

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

[Release No. 34–83062; File No. S7–07–18]

RIN 3235–AM35

### Regulation Best Interest

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** We are proposing a new rule under the Securities Exchange Act of 1934 (“Exchange Act”) establishing a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer.

**DATES:** Comments should be received on or before August 7, 2018.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### *Electronic Comments*

- Use the Commission’s internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7–07–18 on the subject line.

#### *Paper Comments*

- Send paper comments to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–1090.

All submissions should refer to File Number S7–07–18. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s internet website (<http://www.sec.gov/rules/proposed.shtml>). Comments also are available for website viewing and printing in the Commission’s Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of

the inclusion in the comment file of any such materials will be made available on the Commission’s website. To ensure direct electronic receipt of such notifications, sign up through the “Stay Connected” option at [www.sec.gov](http://www.sec.gov) to receive notifications by email.

#### **FOR FURTHER INFORMATION CONTACT:**

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#### **I. Introduction**

Broker-dealers play an important role in helping Americans organize their financial lives, accumulate and manage retirement savings, and invest toward other important long-term goals, such as buying a house or funding a child’s college education. Broker-dealers may offer a wide variety of brokerage (*i.e.*, agency) services to retail customers ranging from providing customers with execution-only services (*e.g.*, discount brokerage), which typically does not involve advice, to providing a range of services, including advice, to customers

(*i.e.*, full-service brokerage).<sup>1</sup> Broker-dealers are typically considered to provide advice when they make recommendations of securities transactions or investment strategies involving securities to customers.<sup>2</sup> Broker-dealers also may offer a variety of dealer (*i.e.*, principal) services and investment products to retail customers,<sup>3</sup> and may make recommendations to retail customers about such principal services, such as recommending transactions where the broker-dealer is buying securities from or selling securities to retail customers on a principal basis or recommending proprietary products.<sup>4</sup> Like many principal-agent relationships, the relationship between a broker-dealer and an investor has inherent conflicts of interest, which may provide an incentive to a broker-dealer to seek to maximize its compensation at the expense of the investor it is advising. As we discuss below, concerns regarding the potential harm to retail customers resulting from broker-dealer conflicts of interest, and in particular the conflicts associated with financial incentives, have existed for some time.

The rule we are proposing today addresses the question of whether changes should be made to the standard of conduct that applies to broker-dealers when making recommendations about securities to retail customers. As discussed below, broker-dealers are

<sup>1</sup> Such “agency” services may include, but are not limited to: Providing transaction-specific recommendations to buy or sell securities for commissions; providing asset allocation services with recommendations about asset classes, specific sectors, or specific securities; providing generalized research, advice, and education; providing custody and trade execution to a customer who has selected an independent investment manager or other money manager; executing trades placed by investment advisers in wrap fee programs; offering margin accounts; and operating a call center (*e.g.*, responding to a customer request for stock quotes, information about an issuer or industry, and then placing a trade at the customer’s request). See, *e.g.*, Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011) (“913 Study”), at 9–10, available at [www.sec.gov/news/studies/2011/913studyfinal.pdf](http://www.sec.gov/news/studies/2011/913studyfinal.pdf).

<sup>2</sup> See 913 Study at 124.

<sup>3</sup> As the Staff noted in the 913 Study, such “dealer” services may include, but are not limited to: Selling securities (such as bonds) out of inventory; buying securities from customers; selling proprietary products (*e.g.*, products such as affiliated mutual funds, structured products, private equity and other alternative investments); selling initial and follow-on public offerings; selling other underwritten offerings; acting as principal in Individual Retirement Accounts (“IRAs”); acting as a market maker; and otherwise acting as a dealer. Broker-dealers may offer solely proprietary products, a limited range of products, or a diverse range of products. *Id.* at 10.

<sup>4</sup> *Id.* at 13.

subject to regulation under the Exchange Act and the rules of each self-regulatory organization (“SRO”) of which the broker-dealer is a member,<sup>5</sup> including a number of obligations that attach when a broker-dealer makes a recommendation to a customer, as well as general and specific requirements aimed at addressing certain conflicts of interest. These obligations have developed in response to and reflect the unique structure and characteristics of the broker-dealer relationship with retail customers—in particular, the compensation and other conflicts presented, the variety in the frequency and level of advice services provided (*i.e.*, one-time, episodic or on a more frequent basis), and the spectrum of services provided to retail customers that may or may not include advice (such as executing unsolicited transactions). While these obligations are extensive, there is no specific obligation under the Exchange Act that broker-dealers make recommendations that are in their customers’ best interest.<sup>6</sup>

After extensive consideration of these issues, we believe it is appropriate to make enhancements to the obligations that apply when broker-dealers make recommendations to retail customers. Accordingly, we are proposing a new rule under the Exchange Act that would establish an express best interest obligation: That all broker-dealers and natural persons who are associated persons of a broker-dealer (unless otherwise indicated, together referred to as “broker-dealer”), when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, 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 or natural person who is an associated person making the recommendation ahead of the interest of

<sup>5</sup> Generally, all registered broker-dealers that deal with the public must become members of the Financial Industry Regulatory Authority (“FINRA”), a registered national securities association, and may choose to become exchange members. See Exchange Act Section 15(b)(8) and Exchange Act Rule 15b9–1. FINRA is the sole national securities association registered with the SEC under Section 15A of the Exchange Act. Accordingly, for purposes of discussing a broker-dealer’s regulatory requirements when providing advice, we focus on FINRA’s regulation, examination and enforcement with respect to member broker-dealers.

<sup>6</sup> As discussed *infra* note 15, FINRA and a number of cases have interpreted FINRA’s suitability rule as requiring a broker-dealer to make recommendations that are “consistent with his customers’ best interests” or are not “clearly contrary to the best interest of the customer,” but this is not an explicit requirement of FINRA’s suitability rule.

the retail customer (“Regulation Best Interest”). The proposed rule would provide that the best interest obligation shall be satisfied if:

- The broker-dealer or natural person who is an associated person of a broker or dealer, prior to or at the time of the recommendation, reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest that are associated with the recommendation;

- The broker-dealer or natural person who is an associated person of a broker or dealer, in making the recommendation, exercises reasonable diligence, care, skill, and prudence to: (1) Understand the potential risks and rewards 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; (2) 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 and rewards associated with the recommendation; and (3) have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer’s best 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;

- The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations; and

- The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

Regulation Best Interest is designed to make it clear that a broker-dealer may not put her or her firm’s financial interests ahead of the interests of her retail customer in making investment recommendations. Our goal in designing proposed Regulation Best Interest is to enhance investor protection, while preserving, to the extent possible, access and choice for investors who prefer the “pay as you go” model for advice from broker-dealers, as well as preserve retail customer choice of the level and types of advice provided and the products available. We believe that the proposed best interest obligation for broker-

dealers set forth in Regulation Best Interest achieves this goal.

Specifically, we believe that proposed Regulation Best Interest will improve investor protection by enhancing the professional standards of conduct that currently apply to broker-dealers when they make recommendations to retail customers, in four key respects.

- First, it would enhance the quality of recommendations provided by requiring broker-dealers make recommendations in the retail customer's "best interest," which incorporates and goes beyond a broker-dealer's existing suitability obligations under the federal securities laws, and could not be satisfied through disclosure alone.<sup>7</sup>

- Second, it would establish obligations under the Exchange Act that do not rely on disclosure alone as the solution to conflicts arising from financial incentives—including conflicts associated with broker-dealer compensation incentives, the sale of proprietary products, and effecting transactions in a principal capacity.

- Third, it would improve disclosure about the scope and terms of the broker-dealer's relationship with the retail customer, which would foster retail customer awareness and understanding of their relationship with the broker-dealer, which aligns with our broader effort to address retail investor confusion through our separate concurrent rulemaking.<sup>8</sup>

<sup>7</sup> As discussed herein, some of the enhancements that Regulation Best Interest would make to existing suitability obligations under the federal securities laws, such as the collection of information requirement related to a customer's investment profile, the inability to disclose away a broker-dealer's suitability obligation, and a requirement to make recommendations that are "consistent with his customers' best interests," reflect obligations that already exist under the FINRA suitability rule or have been articulated in related FINRA interpretations and case law. See *infra* Sections II.D and IV.D, and note 15. Unless otherwise indicated, our discussion of how Regulation Best Interest compares with existing suitability obligations focuses on what is currently required under the Exchange Act.

<sup>8</sup> As discussed in more detail in Section II.D.1 in a separate, concurrent rulemaking, we propose to: (1) Require broker-dealers and investment advisers to deliver to retail investors a short (*i.e.*, four page or equivalent limit if in electronic format) relationship summary; (2) restrict broker-dealers and associated natural persons of broker-dealers, when communicating with a retail investor, from using as part of a name or title the term "adviser" or "advisor" in certain circumstances; and (3) require broker-dealers and investment advisers, and

- Finally, it would enhance the disclosure of material conflicts of interest and thereby help retail customers evaluate recommendations received from broker-dealers.

Through these enhancements, we preliminarily believe that the best interest obligation will reduce the potential harm to retail customers from recommendations provided in circumstances where conflicts of interest, including those arising from financial incentives, exist while preserving investor access to advice and choice with regard to advice relationships and compensation methods, and is workable for the transaction-based relationship offered by broker-dealers. Specifically, proposed Regulation Best Interest is designed to achieve these enhancements by building upon, and being tailored to, the unique structure and characteristics of the broker-dealer relationship with retail customers and existing regulatory obligations, while taking into consideration and drawing on (to the extent appropriate) the principles of the obligations that apply to investment advice in other contexts. In drawing from these underlying principles, as opposed to adopting identical or uniform obligations, we seek to apply consistent principles across the spectrum of investment advice, and thereby enhance investor protection while preserving investor choice across products and advice models.

We further believe that, through the establishment of a standard of conduct for broker-dealers under the Exchange Act, this proposed approach would foster greater clarity, certainty, and efficiency with respect to broker-dealer standards of conduct. In addition, by drawing from principles that have developed under other regulatory regimes, we seek to establish greater consistency in the level of protection provided across the spectrum of registered investment advice and ease compliance with Regulation Best

their associated natural persons and supervised persons, respectively, to disclose in retail investor communications the firm's registration status with the Commission and an associated natural person's and supervised person's relationship with the firm. See *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles*, Release No. 34-83063, IA-4888, File No. S7-08-18 ("Relationship Summary Proposal").

Interest where these other overlapping regulatory regimes are also applicable.

Before describing proposed Regulation Best Interest, we provide a brief background on this subject, including recent Commission and other regulators' considerations of the issues involved, the evolution of our perspective on this subject, and our general objectives in proposing Regulation Best Interest.

#### A. Background

As noted, broker-dealers are subject to comprehensive regulation under the Exchange Act and SRO rules, and a number of obligations attach when a broker-dealer makes a recommendation to a customer. Under the federal securities laws and SRO rules, broker-dealers have a duty of fair dealing,<sup>9</sup> which, among other things, requires broker-dealers to make only suitable recommendations to customers<sup>10</sup> and to receive only fair and reasonable compensation.<sup>11</sup> Broker-dealers are also subject to general and specific requirements aimed at addressing certain conflicts of interest, including

<sup>9</sup> See *Report of the Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 88-95, at 238 (1st Sess. 1963); *In re Richard N. Cea, et al.*, Exchange Act Release No. 8662 at 18 (Aug. 6, 1969) (Commission opinion involving excessive trading and recommendations of speculative securities without a reasonable basis); *In re Mac Robbins & Co. Inc.*, Exchange Act Release No. 6846, 41 SEC. 116 (July 11, 1962); see also FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) (requiring a member, in the conduct of its business, to observe high standards of commercial honor and just and equitable principles of trade).

<sup>10</sup> See *Richard N. Cea*, Exchange Act Release No. 8662; *F.J. Kaufman and Co.*, Securities Exchange Act Release No. 27535 (Dec. 13, 1989); FINRA Rule 2111.01 (Suitability) ("Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of [FINRA's] Rules, with particular emphasis on the requirement to deal fairly with the public. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct."). See also 913 Study at 51-53, 59; *A Joint Report of the SEC and the CFTC on Harmonization of Regulation* (Oct. 2009), available at <http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf>, at 61-64.

<sup>11</sup> See, e.g., FINRA Rules 2121 (Fair Prices and Commissions), 2122 (Charges for Services Performed), and 2341 (Investment Company Securities). See also Exchange Act Sections 10(b) and 15(c).

requirements to eliminate,<sup>12</sup> mitigate,<sup>13</sup> or disclose certain conflicts of interest.<sup>14</sup>

Despite the breadth of a broker-dealer's existing conduct obligations, broker-dealers are not explicitly required to make recommendations that are in a customer's "best interest."<sup>15</sup>

<sup>12</sup> For example, FINRA rules establish restrictions on the use of non-cash compensation in connection with the sale and distribution of mutual funds, variable annuities, direct participation program securities, public offerings of debt and equity securities, and real estate investment trust programs. These rules generally limit the manner in which members can pay or accept non-cash compensation and detail the types of non-cash compensation that are permissible. See FINRA Rules 2310, 2320, 2331, and 5110.

<sup>13</sup> See, e.g., FINRA Rule 3110(c)(3) (firm must have procedures to prevent the effectiveness of an internal inspection from being compromised due to conflicts of interest); FINRA Rule 3110(b)(6)(C) (supervisory personnel generally cannot supervise their own activities); FINRA Rule 3110(b)(6)(D) (firm must have procedures reasonably designed to prevent the required supervisory system from being compromised due to conflicts of interest). Further, a broker-dealer may recommend a security even when a conflict of interest is present, but that recommendation must be suitable. See FINRA Rule 2111. The antifraud provisions of the federal securities laws and the implied obligation of fair dealing prohibit a broker-dealer from, among other things, making unsuitable recommendations and may impose liability on broker-dealers that do not investigate an issuer before recommending the issuer's securities to a customer. See, e.g., *Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969). See also *Municipal Securities Disclosure*, Exchange Act Release No. 26100, at n. 75 (Sept. 22, 1988). The fair dealing obligation also requires a broker-dealer to reasonably believe that its securities recommendations are suitable for its customer in light of the customer's financial needs, objectives and circumstances (customer-specific suitability). See *Richard N. Cea*, Exchange Act Release No. 8662, at 18 (involving excessive trading and recommendations of speculative securities without a reasonable basis).

<sup>14</sup> A broker-dealer may be liable if it does not disclose "material adverse facts of which it is aware." See, e.g., *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970); *SEC v. Hasho*, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992). For example, when engaging in transactions directly with customers on a principal basis, a broker-dealer violates Exchange Act Rule 10b-5 when it knowingly or recklessly sells a security to a customer at a price not reasonably related to the prevailing market price and charges excessive markups (as discussed above), without disclosing the fact to the customer. See, e.g., *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 189-90 (2d Cir. 1998). See also Exchange Act Rule 10b-10 (requiring a broker-dealer effecting transactions in securities to provide written notice to the customer of certain information specific to the transaction at or before completion of the transaction, including the capacity in which the broker-dealer is acting (i.e., agent or principal) and any third-party remuneration it has received or will receive).

<sup>15</sup> While not an explicit requirement of FINRA's suitability rule, FINRA and a number of cases have interpreted the suitability rule as requiring a broker-dealer to make recommendations that are "consistent with his customers' best interests" or are not "clearly contrary to the best interest of the customer." See, e.g., *In re Application of Raghavan Sathianathan*, Exchange Act Release No. 54722 at 21 (Nov. 8, 2006); *In re Application of Dane S. Faber*, Exchange Act Release No. 49216 at 23-24 (Feb. 10, 2004); *In re Powell & McGowan, Inc.*,

Like many principal-agent relationships, the relationship between a broker-dealer and a retail customer has certain inherent and unavoidable conflicts of interest.<sup>16</sup> For example, as a result of

Exchange Act Release No. 7302 (Apr. 24, 1964). In interpretive guidance, FINRA has stated that "[t]he suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests." See FINRA Regulatory Notice 12-25, Additional Guidance on FINRA's New Suitability Rule (May 2012) ("FINRA Regulatory Notice 12-25").

In addition, a broker-dealer may have a fiduciary duty under certain circumstances. This duty may arise under state common law, which varies by state. Generally, courts have found that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, are found to owe customers a fiduciary duty similar to that of investment advisers. See, e.g., *United States v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006); *United States v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002); *Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 212 (7th Cir. 1993); *MidAmerica Fed. Savings & Loan Ass'n v. Shearson/American Express Inc.*, 886 F.2d 1249, 1257 (10th Cir. 1989); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953-954 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981). Cf. *De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293 (2d Cir. 2002) (finding that absent "special circumstances" (i.e., circumstances that render the client dependent—a client with impaired faculties, or one who has a closer than arms-length relationship with the broker, or one who is so lacking in sophistication that de facto control of the account is deemed to rest in the broker-dealer), a broker-dealer does not have a duty to give on-going advice between transactions in a non-discretionary account, even if he volunteered advice at times; "[I]t is uncontested that a broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis. The broker's duties ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice, or warnings concerning the customer's investments. A nondiscretionary customer by definition keeps control over the account and has full responsibility for trading decisions. On a transaction-by-transaction basis, the broker owes duties of diligence and competence in executing the client's trade orders, and is obliged to give honest and complete information when recommending a purchase or sale. The client may enjoy the broker's advice and recommendations with respect to a given trade, but has no legal claim on the broker's ongoing attention.") (citations omitted).

For the staff's discussion of relevant case law see 913 Study, at 54-55. See also *A Joint Report of the SEC and the CFTC on Harmonization of Regulation* (Oct. 2009), available at <http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf>, at 8-9 and 67. See also Section II.F. for a discussion and request for comment regarding broker-dealer exercise of discretion and the extent to which such exercise is "solely incidental" to the conduct of its business as a broker-dealer.

<sup>16</sup> See *infra* Section IV.B.1. For instance, in the past, brokerage firms have been fined for placing customers in fee-based brokerage accounts that generated higher fees for the firm, where such accounts were not appropriate for the customer. See, e.g., NASD News Release, NASD Fines Raymond James \$750,000 for Fee-Based Account Violations (Apr. 27, 2005), available at <http://www.finra.org/newsroom/2005/nasd-fines-raymond-james-750000-fee-based-account>

transaction-based compensation structures, broker-dealers often make recommendations to retail customers against a backdrop of potential conflicts that may provide them with an incentive to seek to increase their compensation at the expense of the investors they are advising. In addition, other conflicts of interest arise out of business activities that broker-dealers may choose to engage in (including, among others, receipt of third-party compensation, principal trading, and the sale of proprietary or affiliated products). The Commission believes that material conflicts of interest associated with the broker-dealer relationship need to be well understood by the retail customer and, in some cases, mitigated or eliminated.<sup>17</sup>

In this regard, it has been asserted that (1) retail customers do not sufficiently understand the broker-dealer relationship, and in particular the conflicts presented by broker-dealer compensation arrangements and practices when making a recommendation, and (2) regardless of the sufficiency of the retail customer's understanding of the broker-dealer structure, broker-dealer regulatory requirements do not require a broker-dealer's recommendations to be in a customer's best interest and require limited disclosure that may not appropriately address the conflicts of interest presented.<sup>18</sup>

violations (finding that Raymond James violated NASD rules by recommending and opening fee-based brokerage accounts for customers without first determining whether the accounts were appropriate and by allowing those accounts to remain open). See also NYSE Hearing Board Decision 06-133 (July 10, 2006), available at <https://www.nyse.com/publicdocs/nyse/markets/nyse/disciplinary-actions/2006/06-133.pdf> (finding that A.G. Edwards had wrongfully placed customers into non-managed fee accounts in lieu of commission-based accounts, where non-managed fee-based brokerage accounts were not appropriate for buy-and-hold investors or for investors with few transactions, which resulted in such investors paying substantially more in fees than they would have paid under a commission-based structure); FINRA Press Release, FINRA Fines Robert W. Baird & Co. \$500,000 for Fee-Based Account, Breakpoint Violations (Feb. 18, 2009), available at <http://www.finra.org/newsroom/2009/finra-fines-robert-w-baird-co-500000-fee-based-account-breakpoint-violations> (finding that Robert W. Baird & Co. failed to adequately review customer accounts that were transferred into a fee-based brokerage program, allowing numerous customers to remain in the program despite conducting no trades, where the firm continued to receive substantial fees despite inactivity on customers' accounts).

<sup>17</sup> See *infra* Section II.D.3.

<sup>18</sup> See, e.g., Letter from Marnie C. Lambert, President, Public Investors Arbitration Bar Association (Aug. 11, 2017) ("PIABA Letter") ("The Suitability Rule is not sufficient on its own to remove and manage these conflicts and ensure that brokers have acted in their clients' best interests. . . . Any standards adopted by the SEC

Continued

These concerns are not new. The Commission has previously expressed long-held concerns about the incentives that commission-based compensation provides to churn accounts, recommend unsuitable securities, and engage in aggressive marketing of brokerage services.<sup>19</sup> This apprehension about the potentially harmful effects of conflicts has been reflected over the years in, among other things, our National Examination Program's examination priorities, which have continually included conflicts of interest as an exam focus—either generally or specifically (e.g., the role of conflicts of interest in and suitability of recommendations involving retirement accounts (such as investment or rollover recommendations), complex or structured products, variable annuities, higher yield securities, exchange traded funds, and mutual fund share class selection (*i.e.*, share classes with higher loads or distribution fees)—for many years.<sup>20</sup> As our exam staff has noted,

should acknowledge that conflicts of interest are pervasive throughout the industry and firms will continue to face challenges when trying to balance the interests of their clients with those conflicts. Any standards adopted should require mitigation of conflicts of interest to the extent possible.”); Letter from Kevin R. Keller, Chief Executive Officer, CFP Board, et al., Financial Planning Coalition (Nov. 7, 2017) (“Financial Planning Coalition Letter”) (stating that FINRA’s suitability rule “fails to mandate disclosure of actual or potential conflicts of interest, proscribe appropriate mitigation mechanisms, or require that broker-dealers put the client’s interests above their own earned commissions”).

<sup>19</sup> These concerns led former Chairman Arthur Levitt to form the Committee on Compensation Practices to review industry compensation practices, identify actual and perceived conflicts of interest, and identify “best practices” to eliminate, reduce, or mitigate these conflicts. See Report of the Committee on Compensation Practices (Apr. 10, 1995) (“Tully Report”). The Tully Report observed that although the commission-based compensation system “works remarkably well for the vast majority of investors,” conflicts of interest persist that can damage the interest of retail customers, and identified various “best practices” for addressing broker-dealer and registered representative compensation-related conflicts, including fee-based brokerage accounts. *Id.* In 2005, the Commission adopted Rule 202(a)(11)–1 under the Advisers Act, the principal purpose of which was to deem broker-dealers offering “fee-based brokerage accounts” as not being subject to the Advisers Act. See *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Exchange Act Release No. 51523 (Apr. 12, 2005) at 8 (“Release 51523”) (adopting rule 202(a)(11)–1 under the Advisers Act). This rule was later vacated by the Court of Appeals for the District of Columbia Circuit. See *Fin. Planning Ass’n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

<sup>20</sup> See Office of Compliance Inspections and Examinations (“OCIE”), Examination Priorities for 2013 (Feb. 21, 2013), available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf> (“2013 Exam Priorities”); OCIE, Examination Priorities for 2014 (Jan. 9, 2014), available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf>; OCIE, Examination Priorities for 2015 (Jan. 13, 2015),

“[c]onflicts of interest, when not eliminated or properly mitigated and managed, are a leading indicator and cause of significant regulatory issues for individuals, firms and sometimes the entire market.”<sup>21</sup>

FINRA has similarly focused on the potential risks to broker-dealers and to retail customers presented by broker-dealer conflicts, and impact on brokerage recommendations, as reflected in guidance addressing and highlighting circumstances in which various broker-dealer conflicts of interest may create incentives that are contrary to the interest of retail customers.<sup>22</sup> Most notably, in 2013, FINRA published a report on conflicts of interest in the broker-dealer industry to highlight effective conflicts management practices.<sup>23</sup> At the time of publication of the FINRA Conflicts Report, FINRA Chairman and Chief Executive Officer (“CEO”) Richard Ketchum noted that “[w]hile many firms have made progress in improving the way they manage conflicts, our review reveals that firms should do more.”<sup>24</sup> He later observed that “some firms continue to approach conflict management on a haphazard basis, only implementing an effective supervisory process after a failure event involving customer harm occurs,” and suggested the development of a best interest standard that includes, among other things, “a requirement that financial firms establish carefully designed and

available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf>; OCIE, Examination Priorities for 2016 (Jan. 11, 2016), available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf>; OCIE, Examination Priorities for 2017 (Jan. 12, 2017), available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf>. See also OCIE Risk Alert, “Retirement-Targeted Industry Reviews and Examinations Initiative” (June 22, 2015), <http://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf>.

<sup>21</sup> 2013 Exam Priorities.

<sup>22</sup> See, e.g., FINRA Regulatory Notice 13–45, Rollovers to Individual Retirement Accounts: FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers (Dec. 2013) (“FINRA Regulatory Notice 13–45”), available at <http://www.finra.org/sites/default/files/NoticeDocument/p418695.pdf>. (noting the economic incentive a financial professional has to encourage an investor to roll plan assets into an IRA that he will represent as either a broker-dealer or an investment adviser representative).

<sup>23</sup> See FINRA Report on Conflicts of Interest (Oct. 2013), available at <https://www.finra.org/sites/default/files/industry/p359971.pdf> (“FINRA Conflicts Report”).

<sup>24</sup> See Statement from Chairman and CEO Richard G. Ketchum on FINRA’s Report on Conflicts of Interest (Oct. 14, 2013), available at <http://www.finra.org/newsroom/2013/statement-chairman-and-ceo-richard-g-ketchum-finras-report-conflicts-interest>.

articulated structures to manage conflicts of interest that arise in their businesses.”<sup>25</sup> In 2015, FINRA launched a targeted exam regarding incentive structures and conflicts of interest in connection with firms’ retail brokerage business, which encompassed firms’ conflict mitigation processes regarding compensation plans for registered representatives, and firms’ approaches to mitigating conflicts of interest that arise through the sale of proprietary or affiliated products, or products for which a firm receives third-party payments (e.g., revenue sharing).<sup>26</sup>

These concerns about the potential harms that may result from broker-dealer conflicts of interest have been echoed by commenters over the years. Recent commenters’ analyses suggest that retail customers have been harmed by conflicted advice, such as the incentives created by broker-dealer compensation arrangements, due to the lack of an explicit “best interest” obligation applying to such advice.<sup>27</sup>

At the same time, many retail customers generally and reasonably expect that their investment firms and professionals, including broker-dealers, will—and rely on them to—provide advice that is in their best interest by placing investors’ interest before their own. Studies have documented that many retail customers who use the services of broker-dealers and investment advisers are not aware of the differences in regulatory approaches for these entities, and their associated persons, and the differing duties that flow from them.<sup>28</sup> Commenters assert

<sup>25</sup> See Richard G. Ketchum, Remarks From the 2015 FINRA Annual Conference (May 27, 2015), available at <https://www.finra.org/newsroom/speeches/052715-remarks-2015-finra-annual-conference>.

<sup>26</sup> See FINRA 2016 Regulatory and Examination Priorities Letter (Jan. 5, 2016), available at <http://www.finra.org/sites/default/files/2016-regulatory-and-examination-priorities-letter.pdf>. See also Conflicts of Interest Review—Compensation and Oversight (Apr. 2015), available at <http://www.finra.org/industry/conflicts-interest-review-compensation-and-oversight>.

<sup>27</sup> See, e.g., Letter from Monique Morrissey, Ph.D., Economist, and Heidi Shierholz, Economist and Director of Policy; Economic Policy Institute (Oct. 5, 2017) (“Economic Policy Institute Letter”); Letter from Americans for Financial Reform (Sept. 22, 2017) (“AFR Letter”); Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America (“CFA”) (Sept. 14, 2017) (“CFA 2017 Letter”); PIABA Letter (“Conflicted advice causes substantial harm to investors. Just looking at retirement savers, *SaveOurRetirement.com* estimates that investors lose between \$57 million and \$117 million every day due to conflicted investment advice, amounting to at least \$21 billion annually.”)

<sup>28</sup> In 2006, the SEC retained the RAND Corporation’s Institute for Civil Justice (“RAND”) to conduct a survey, which concluded that the distinctions between investment advisers and broker-dealers have become blurred, and that

that any confusion regarding the standards of conduct that apply may only enhance the potential for harm from broker-dealer conflicts of interest, as this confusion results in retail customers mistakenly relying on those recommendations as being in their “best interest.”<sup>29</sup> Commenters have further observed that having differing standards apply to the advice broker-dealers provide, in particular with respect to advice provided to retirement versus non-retirement assets, will create different levels of advice depending on the type of account and will only further this investor confusion.<sup>30</sup>

There is broad acknowledgement of the benefits of, and support for, the continuing existence of the broker-dealer model as an option for retail customers seeking investment advice, notwithstanding the concerns regarding broker-dealer conflicts (including the transaction-based compensation model) and retail customer confusion regarding these conflicts and the limits of the applicable regulations.<sup>31</sup> Among other things, the Commission and our staff, commenters and others have recognized the benefits of the broker-dealer model for advice and the access to advice and the choice of products, services and payment options, that the brokerage

market participants had difficulty determining whether a financial professional was an investment adviser or a broker-dealer and instead believed that investment advisers and broker-dealers offered the same services and were subject to the same duties. RAND noted, however, that generally investors they surveyed as part of the study were satisfied with their financial professional, be it a representative of a broker-dealer or an investment adviser. Angela A. Hung, et al., *RAND Institute for Civil Justice, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (2008) (“RAND Study”). See also Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, et al., (Sept. 15, 2010) (submitting the results of a national opinion survey regarding U.S. investors and the fiduciary standard conducted by ORC/Infogroup for the Consumer Federation of America, AARP, the North American Securities Administrators Association, the Certified Financial Planner Board of Standards, Inc., the Investment Adviser Association, the Financial Planning Association and the National Association of Personal Financial Advisors (“CFA 2010 Survey”).

<sup>29</sup> CFA 2017 Letter.

<sup>30</sup> See, e.g., Letter from Kirt A. Walker, President and Chief Operating Officer, Nationwide Financial (Nov. 2, 2017) (“Nationwide Letter”); Letter from Deneen L. Donnley, Executive Vice President, Chief Legal Officer Corp, USAA (Aug. 31, 2017) (“USAA Letter”); Letter from Dorothy M. Donohue, Acting General Counsel, Investment Company Institute (Aug. 7, 2017) (“ICI August 2017 Letter”).

<sup>31</sup> See, e.g., Letter from Barbara Roper, Director of Investor Protection, CFA to the Department of Labor (Oct. 3, 2017) (acknowledging that some customers are better off in commission accounts); see also Tully Report; 913 Study at 151–54 (discussing potential costs to retail investors, including loss of choice, if the broker-dealer exclusion from the Advisers Act were eliminated).

model provides retail customers.<sup>32</sup> Moreover, the Commission is aware that certain conflicts of interest are inherent in other principal-agent relationships.<sup>33</sup> The issue at hand, therefore, is how we should address these concerns in a manner that both improves investor protection and preserves these beneficial characteristics—in particular choice regarding access to a variety of products and advice relationships.

#### 1. Evaluation of Standards of Conduct Applicable to Investment Advice

The Commission and its staff have been evaluating the standards applicable to investment advice for some time. In the past, the Commission observed that the lines between full-service broker-dealers and investment advisers have blurred, and expressed concern when specific regulatory obligations depend on the statute under which a financial intermediary is registered instead of the services provided.<sup>34</sup> At the same time, we acknowledged that the Exchange Act, the rules thereunder, and SRO rules provide substantial protections for broker-dealer customers, and expressed that we did not believe that requiring most or all full-service broker-dealers to treat most or all of their customer accounts as advisory accounts would be an appropriate response to this blurring.<sup>35</sup>

In 2011, the Commission staff issued the 913 Study, which was mandated by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), in

<sup>32</sup> See *id.* See also Nationwide Letter; Letter from James D. Gallagher, Executive Vice President and General Counsel, John Hancock Life Insurance Company (U.S.A.) (Aug. 25, 2017) (“John Hancock Letter”); Letter from Craig S. Tyle, Executive Vice President and General Counsel, Franklin Templeton Investments (“Franklin Templeton Letter”) (Aug. 7, 2017); ICI August 2017 Letter; USAA Letter.

<sup>33</sup> Conflicts of interest are not unique to the broker-dealer commission-based relationship. A firm may earn more revenue in a fee-based account rather than a commission-based account, and may therefore have an incentive to recommend such a fee-based account even if a commission-based advice relationship would be appropriate and less costly for the customer. Customers with low trading activity or long-term buy-and-hold investors in particular may pay less in a commission-based account. An asset-based fee for advice also creates a conflict because the firm is paid regardless of whether it services the account, creating a disincentive to act. In addition, a firm may have an incentive to recommend that a customer maintain assets in either a fee-based account or a commission-based account, even though it would be more appropriate for the customer to use assets in the account to, for example, pay off an outstanding loan, because the firm could continue to earn either kind of fee while the assets remain in the account.

<sup>34</sup> See Release 51523; see also Request, *infra* note 40.

<sup>35</sup> Release 51523 at 3, 35.

which they made recommendations to the Commission that the staff believed would enhance retail customer protections and decrease retail customers’ confusion about the standard of conduct owed to them when their financial intermediary provided them personalized investment advice.<sup>36</sup> One of the staff’s primary recommendations was that the Commission engage in rulemaking to adopt and implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. The staff’s recommended standard would require firms “to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice.”<sup>37</sup>

The staff made a number of specific recommendations for implementing the uniform fiduciary standard of conduct, including that the Commission should: (1) Require firms to eliminate or disclose conflicts of interest; (2) consider whether rulemaking would be appropriate to prohibit certain conflicts, to require firms to mitigate conflicts through specific action, or to impose specific disclosure and consent requirements; and (3) consider specifying uniform standards for the duty of care owed to retail customers, such as specifying what basis a broker-dealer or investment adviser should have in making a recommendation to a retail customer by referring to and expanding upon broker-dealers’ existing suitability requirements.<sup>38</sup>

The staff explained that the recommendations were intended to, among other things, heighten investor protection, address retail customer confusion about the obligations broker-dealers and investment advisers owe to those customers, and preserve retail customer choice without decreasing retail customers’ access to existing products, services, service providers, or compensation structures.<sup>39</sup>

Following the 913 Study, in 2013 the Commission issued a request for information (“Request”) seeking additional information from the public to assist the Commission in evaluating whether and how to address certain standards of conduct for, and regulatory obligations of, broker-dealers and investment advisers.<sup>40</sup> The Request

<sup>36</sup> See 913 Study, *supra* note 1.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> See 913 Study at viii, x, 101, 109, 166.

<sup>40</sup> See Request for Data and Other Information: Duties of Brokers, Dealers and Investment Advisers,

sought information on the benefits and costs of the current standards of conduct for broker-dealers and investment advisers, as well as alternative approaches to the standards of conduct, including a uniform fiduciary standard.

The Commission received more than 250 comment letters from industry groups, individual market participants, and other interested persons in response to the Request.<sup>41</sup> The vast majority of commenters provided qualitative responses to the specific assumptions contained in the Request, while a few industry commenters submitted surveys and other quantitative data. Most commenters expressed support for a uniform fiduciary standard of conduct requiring firms to “act in the best interest” of the investor although they had different views of what the standard would require and expressed concerns about its implementation.<sup>42</sup>

In November 2013, the Commission’s Investor Advisory Committee (“IAC”) adopted a recommendation on implementing a uniform fiduciary standard (as proposed by the Investor as Purchaser Subcommittee).<sup>43</sup> In the IAC’s view, the current regulatory regime for broker-dealers does not offer adequate investor protection when broker-dealers

are providing advice, as under the suitability standard, broker-dealers generally remain free to place their own interests ahead of the interest of their customers.<sup>44</sup> The IAC also expressed its view that any economic analysis should acknowledge the existence and importance of investor harm that can result from the current suitability standard.<sup>45</sup> In considering the optimal regulatory approach to take with respect to imposing a fiduciary duty on broker-dealers, the overarching recommendation from the IAC was that “the Commission should weigh its various options with an eye toward determining which will best ensure an outcome that strengthens investor protections, preserves investor choice with regard to business models and compensation methods, and is workable for broker-dealers and investment advisers alike.”<sup>46</sup> The IAC recommended to the Commission two options for imposing a fiduciary duty on broker-dealers when they are providing personalized advice to retail investors: (1) Narrow the broker-dealer exclusion from the definition of “investment adviser” under the Investment Advisers Act of 1940 (“Advisers Act”) (the IAC’s preferred approach); or (2) engage in rulemaking under Section 913 to adopt a principles-based fiduciary duty that is “no weaker” than the standard under the Advisers Act; permit certain sales-related conflicts as long as conflicts are fully disclosed and appropriately managed; and consider whether certain sales practices, conflicts of interest, or compensation schemes should be prohibited or restricted.<sup>47</sup>

## 2. DOL Rulemaking

The Department of Labor (“DOL”) has also engaged in rulemaking to broaden the definition of “fiduciary” in connection with providing investment advice under the Employee Retirement Income Security Act of 1974 (“ERISA”) and the Internal Revenue Code of 1986 (“Code”).<sup>48</sup> Commission staff provided DOL staff with technical assistance and

expertise on our regulatory regime as DOL developed its rulemaking.<sup>49</sup>

On April 8, 2016, DOL adopted a new, expanded definition of “fiduciary” that treats persons who provide investment advice or recommendations for a fee or other compensation with respect to assets of an ERISA plan or IRA as fiduciaries in a wider array of advice relationships than under the previous regulation (“DOL Fiduciary Rule”).<sup>50</sup> On March 15, 2018, the DOL Fiduciary Rule was vacated by the United States Court of Appeals for the Fifth Circuit.<sup>51</sup>

We understand that the DOL Fiduciary Rule would broadly expand the circumstances in which broker-dealers making recommendations to ERISA plans and ERISA plan participants may be fiduciaries under ERISA, and thus subject to ERISA’s prohibited transaction provisions. Similarly, it would expand the circumstances in which broker-dealers providing recommendations to IRAs would be subject to the prohibited transaction provisions of the Code.<sup>52</sup> Among other things, these prohibited transactions provisions generally would prohibit such a fiduciary from engaging in self-dealing and receiving compensation from third parties in connection with transactions involving a plan or IRA, and from acting on conflicts of interest, including using their authority to affect or increase their own compensation, in connection with transactions involving a plan or IRA, or from purchasing or selling any property to ERISA plans or IRAs.<sup>53</sup> As a result, we understand that—in the absence of an exemption from the DOL—broker-dealers that would be considered to be a “fiduciary” under the DOL Fiduciary Rule would not only be prohibited from engaging in purchases and sales of certain investments for their own account (*i.e.*, engaging in principal transactions), but more significantly, would be prohibited from receiving

Exchange Act Release No. 69013 (Mar. 1, 2013), available at <http://www.sec.gov/rules/other/2013/34-69013.pdf>; see also *SEC Seeks Information to Assess Standards of Conduct and Other Obligations of Broker-Dealers and Investment Advisers* (press release), available at <http://www.sec.gov/news/press/2013/2013-32.htm>.

<sup>41</sup> Comments submitted in response to the Request are available at <https://www.sec.gov/comments/4-606/4-606.shtml>.

<sup>42</sup> For example, some commenters supported a new uniform, rules-based fiduciary standard of conduct that is tailored to broker-dealers’ business models, but also expressed concern about, among other things, the costs of implementation, the need to preserve investor choice and avoid regulatory duplication or conflict. See, e.g., Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association (“SIFMA”) (July 5, 2013). Others tended to support a uniform fiduciary standard of conduct that is “no less stringent” than the current standard under the Advisers Act (*i.e.*, extending the current standard of conduct to broker-dealers), but were concerned about “watering down” the current Advisers Act standard to accommodate broker-dealers’ business models. See, e.g., Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America (July 5, 2013); Letter from David G. Tittsworth, Executive Director, Investment Adviser Association (July 3, 2013).

<sup>43</sup> Recommendation of the Investor Advisory Committee: Broker-Dealer Fiduciary Duty (Nov. 2013) (“IAC Recommendation”), available at <https://www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation-2013.pdf>. The IAC also recommended that the Commission engage in rulemaking to adopt a uniform, plain English disclosure document that includes certain basic information (*e.g.*, fees and conflicts of interest). *Id.* We are considering this recommendation separately as part of the Relationship Summary Proposal.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> See Definition of the Term “Fiduciary” Conflict of Interest Rule—Retirement Investment Advice, 81 FR 20945, 20958–59 (Apr. 8, 2016) (to be codified at 29 CFR pts. 2509, 2510, 2550) (“DOL Fiduciary Rule Release”). The DOL has authority to issue regulations under ERISA and prohibited transaction provisions under the Code, including authority to define the circumstances in which persons, including broker-dealers and investment advisers, are “fiduciaries” for purposes of ERISA and the Code as a result of providing “investment advice” to plans and IRAs.

<sup>49</sup> See *id.*

<sup>50</sup> 29 CFR 2510.3–21 (effective June 9, 2017). This rule also applies to the definition of fiduciary in the prohibited transaction provisions under the Code. See 29 CFR 2510.3–21(F). See also DOL Fiduciary Rule Release.

<sup>51</sup> *Chamber of Commerce of the U.S.A., et al. v. U.S. Dep’t of Labor, et al.*, No. 17–10238 (5th Cir.) (Mar. 15, 2018).

<sup>52</sup> See Best Interest Contract Exemption, 81 FR 21002, 21089 (Apr. 8, 2016) (“BIC Exemption Release”), as corrected Best Interest Contract Exemption; Correction (Prohibited Transaction Exemption 2016–01), 81 FR 44773 (July 11, 2016) (“BIC Exemption”). DOL stated in the BIC Exemption Release that it “anticipates that the [DOL Fiduciary Rule] will cover many investment professionals who did not previously consider themselves to be fiduciaries under ERISA or the Code.”

<sup>53</sup> See BIC Exemption Release at 21002.

common forms of broker-dealer compensation (notably, transaction-based compensation), which would effectively eliminate a broker-dealer's ability or willingness to provide investment advice with respect to investors' retirement assets.<sup>54</sup>

To avoid this result, in connection with the DOL Fiduciary Rule, DOL published two new administrative class exemptions from the prohibited transaction provisions of ERISA and the Code—the Best Interest Contract Exemption (“BIC Exemption”) and the Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (“Principal Transactions Exemption”)—as well as amendments to previously granted prohibited transaction exemptions (collectively referred to as “PTEs”).<sup>55</sup> The BIC Exemption and the Principal Transactions Exemption would allow persons who are deemed investment advice fiduciaries under the DOL Fiduciary Rule, such as broker-dealers, to receive various forms of compensation (e.g., brokerage commissions) and to engage in certain principal transactions, respectively, that in the absence of an exemption, would be prohibited under ERISA and the Code.<sup>56</sup>

<sup>54</sup> See generally BIC Exemption; Principal Transactions Exemption, *infra* note 55.

<sup>55</sup> See, e.g., BIC Exemption Release (permitting certain “Financial Institutions” and “Advisers” to receive compensation resulting from a provision of investment advice in connection with securities transactions, including riskless principal transactions); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (Prohibited Transaction Exemption 2016–02), 81 FR 21089, 21105–10 (Apr. 8, 2016) (“Principal Transactions Release”); corrected at Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs, 81 FR 44784 (July 11, 2016) (“Principal Transactions Exemption”) (permitting investment advice fiduciaries to sell or purchase certain debt securities and other investments in principal transactions and riskless principal transactions). See also Amendment to and Partial Revocation of Prohibited Transaction Exemption (PTE) 86–128 for Transactions Involving Employee Benefit Plans and Broker-Dealers; Amendment to and Partial Revocation of PTE 75–1, Exemptions from Prohibitions Respecting Certain Classes of Transactions Involving Employee Benefit Plans and Certain Broker-Dealers, Reporting Dealers and Banks, 81 FR 21181 (Apr. 8, 2016) (permitting broker-dealers exercising investment discretion to receive commissions and other fees for effecting securities transactions as agent for a plan or IRA, under certain conditions, including Impartial Conduct Standards like those applicable under the BIC Exemption); DOL Fiduciary Rule Release, *supra* note 48, 81 FR at 20991 (describing the new BIC Exemption, Principal Transactions Exemption, and amendments to existing PTEs).

<sup>56</sup> See generally BIC Exemption; Principal Transactions Exemption.

Specifically, the BIC Exemption would provide conditional relief for an “adviser,” as that term is used in the context of the BIC Exemption,<sup>57</sup> and the adviser's firm, to receive common forms of “conflicted” compensation, such as commissions and third-party payments (such as revenue sharing), provided that the adviser's firm meets certain conditions.<sup>58</sup> Generally, the BIC Exemption would require that the advice must be provided pursuant to a written contract executed between the adviser's firm and the investor (and enforceable against the adviser's firm).<sup>59</sup> The contract must include specific language and disclosures, including (among others) provisions: Acknowledging fiduciary status; committing the firm and the adviser to adhere to standards of impartial conduct (*i.e.*, providing advice in the investor's best interest; charging only reasonable compensation; and avoiding misleading statements about fees and conflicts of interest) (“Impartial Conduct Standards”); and warranting the adoption of policies and procedures reasonably designed to ensure that advisers provide best interest advice and minimize the harmful impact of conflicts of interest. The firm must also disclose information on the firm's and advisers' conflicts of interest and the cost of their advice and provide certain ongoing web disclosures.<sup>60</sup> As noted above, we understand that, as a practical matter, most broker-dealers offering IRA brokerage accounts would need to meet the conditions of the BIC Exemption to advise (*i.e.*, make recommendations to) brokerage customers with IRA accounts and to receive transaction-based and other compensation (including amounts paid from third parties, such as 12b–1

<sup>57</sup> The DOL explains that by using the term “adviser,” it “does not intend to limit the exemption to investment advisers registered under the Investment Advisers Act of 1940 or under state law,” and that rather, for purposes of the BIC Exemption, an adviser “is an individual who can be a representative of a registered investment adviser, a bank or similar financial institution, an insurance company, or a broker-dealer.” BIC Exemption Release, *supra* note 52, 81 FR at 21003, n.2.

<sup>58</sup> See BIC Exemption Release. ERISA and the Code generally prohibit fiduciaries from receiving payments from third parties and from acting on conflicts of interest, including using their authority to affect or increase their own compensation, in connection with transactions involving a plan or IRA. Certain types of fees and compensation common in the retail market, such as brokerage or insurance commissions, rule 12b–1 fees and revenue sharing payments, may fall within these prohibitions when received by fiduciaries as a result of transactions involving advice to the plan, plan participants and beneficiaries, and IRA owners. *Id.*

<sup>59</sup> See BIC Exemption Release.

<sup>60</sup> See BIC Exemption.

fees) in connection with their securities recommendations.

Generally, the Principal Transactions Exemption would (1) permit certain principal transactions involving the purchase of limited securities (*i.e.*, certificates of deposits, interests in unit investment trusts, and certain debt securities)<sup>61</sup> by a plan or an IRA owner and (2) more broadly permit principal transactions involving the sale of “securities or other investment property” by the plan or IRA owner, conditioned on adherence to, among other things, Impartial Conduct Standards,<sup>62</sup> as well as a contract requirement and a policies and procedures warranty that mirror the requirements in the BIC Exemption.<sup>63</sup> The Principal Transactions Exemption also includes some conditions that are different from those in the BIC Exemption, including credit and liquidity standards for debt securities sold to plans and IRAs pursuant to the exemption and additional disclosure requirements.<sup>64</sup>

The revised definition of “fiduciary,” as well as the Impartial Conduct Standards, became effective on June 9, 2017.<sup>65</sup> Compliance with the remaining

<sup>61</sup> Debt securities are generally registered corporate debt securities, treasury securities, agency securities, and asset-backed securities that are guaranteed by an agency or government sponsored enterprise. See Principal Transactions Exemption.

<sup>62</sup> In the Principal Transactions Exemption, the Impartial Conduct Standards specifically refer to the fiduciary's obligation to seek to obtain the best execution reasonably available under the circumstances with respect to the transaction, rather than to receive no more than “reasonable compensation.” See Principal Transactions Exemption. The Principal Transactions Exemption provides that the adviser may satisfy the obligation under the exemption to obtain best execution reasonably available under the circumstances with respect to the transaction by complying with FINRA rules on fair pricing and best execution (Rules 2121—Fair Prices and Commissions; 5310—Best Execution and Interpositioning). See Principal Transactions Exemption, Section II(c)(2)(i).

<sup>63</sup> See Principal Transactions Exemption; 18-Month Extension of Transition Period and Delay of Applicability Dates; Best Interest Contract Exemption (PTE 2016–01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (PTE 2016–02); Prohibited Transaction Exemption 84–24 for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, and Investment Company Principal Underwriters (PTE 84–24), 82 FR 56545 (Nov. 29, 2017) (“DOL November Extension”), available at <https://federalregister.gov/d/2017-25760>.

<sup>64</sup> See Principal Transactions Exemption; DOL November Extension.

<sup>65</sup> See Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice; Best Interest Contract Exemption (Prohibited Transaction Exemption 2016–01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (Prohibited



conditions of the BIC Exemption and the Principal Transaction Exemption, such as the general contract requirement, and conditions requiring specific written warranties and disclosures, has been delayed until July 1, 2019.<sup>66</sup> During this transition period, “financial institutions” and “advisers,” as defined in the PTEs, are currently only required to comply with the Impartial Conduct Standards to satisfy the conditions of these PTEs.<sup>67</sup>

### 3. Statement by Chairman Clayton

In light of the DOL Fiduciary Rule and related PTEs, and in recognition of the significant developments in the marketplace that have occurred since the Commission last solicited information from the public in 2013, Chairman Clayton issued a statement on June 1, 2017 containing a number of questions regarding standards of conduct for investment advisers and broker-dealers.<sup>68</sup> The public input was intended to provide the Commission with an updated assessment of the current regulatory framework, the current state of the market for retail investment advice, and market trends.<sup>69</sup> Chairman Clayton also invited commenters to submit data and other information that may inform the Commission’s analysis, including data covering periods since the 2013 solicitation of comment.

To date, over 250 comments have been received from the public in response to the Chairman Clayton Statement. While some commenters opposed any changes to the standard of conduct<sup>70</sup> and offered other options,<sup>71</sup>

for the most part, commenters support changes to the standards of conduct for investment advice, and in particular the establishment of a fiduciary or best interest standard specific to broker-dealers<sup>72</sup> or, alternatively, a standard of conduct that uniformly applies to investment advisers and broker-dealers.<sup>73</sup>

Letter from Mark D. Moss (June 2, 2017) (supporting SEC involvement in standardizing nomenclature).

<sup>72</sup> See, e.g., CFA 2017 Letter (supporting the Commission taking a “more rigorous approach” to interpreting the fiduciary standard by developing a new standard for brokers under the [Securities Exchange Act of 1934] and in enforcing the existing standard under the Advisers Act and stating that the fiduciary duty must include a principles-based, legally enforceable best interest standard); Letter from Gail C. Bernstein, General Counsel, Investment Advisers Association (Aug. 31, 2017) (“IAA Letter”) (recommending the SEC develop a best interest standard for brokers that is as robust as the fiduciary standard under the Advisers Act); ICI August 2017 Letter (supporting the SEC taking the lead in establishing and enforcing a best interest standard of conduct for broker-dealers providing recommendations to retail investors); Letter from Kevin Carroll, Managing Director and Associate General Counsel, SIFMA (July 21, 2017) (“SIFMA Letter”) (suggesting the SEC consider a best interest standard for broker-dealers that encompasses the duty of loyalty, duty of care and enhanced up-front disclosures); Letter from Timothy E. Keehan, Vice President, Senior Counsel, American Bankers Association (Sept. 1, 2017) (“ABA Letter”); Letter from David Kowach, Head of Wells Fargo Advisors, Wells Fargo & Company (Sept. 20, 2017) (“Wells Fargo Letter”) (“[We] recommend the SEC establish and enforce a best interest standard of conduct for broker-dealers when they provide personalized investment advice to retail investors that is aligned with the standard of conduct applicable to registered investment advisors.”); Letter from Marc R. Bryant, Senior Vice President and Deputy General Counsel, Fidelity Investments (Aug. 11, 2017) (“Fidelity Letter”) (“Fidelity believes that the SEC should review and consider an enhanced best interest standard of conduct for broker-dealers that is clearly defined, disclosure and materiality-based, and that applies across all of an investor’s brokerage accounts and interactions”); Letter from F. William McNabb, Chairman and Chief Executive Officer, The Vanguard Group, Inc. (Sept. 29, 2017) (“Vanguard Letter”); Letter from Derek B. Dorn, Managing Director, Regulatory Engagement and Policy, TIAA (Sept. 26, 2017) (“TIAA Letter”) (supporting application of a best interest standard of conduct to all personalized investment advice provided to retail investors through raising the broker-dealer standard and maintaining the investment adviser standard); Letter from Robert Grohowski, Vice President, Senior Legal Counsel—Legislative and Regulatory Affairs, T. Rowe Price (Oct. 12, 2017) (“T. Rowe Letter”) (“Given the history, we believe that the SEC’s best path forward would be to focus specifically on updating the standard applicable to non-discretionary broker-dealer recommendations, irrespective of account type.”); Letter from Americans for Financial Reform (Sept. 22, 2017) (“AFR Letter”) (proposing extension of a strong fiduciary “best interest” standard to all those who hold themselves out as advisers or offer personalized investment advice to clients and focusing on broker-dealer business model).

<sup>73</sup> See, e.g., Letter from David Certner, Legislative Counsel & Legislative Policy Director, Government Affairs, AARP (Sept. 6, 2017) (“AARP Letter”) (“Adoption of a uniform standard that would apply to both broker-dealers and investment advisers when providing personalized investment advice to

In addition to this statement, Chairman Clayton and the staff have continually engaged in other outreach, including meetings with retail investors, investor advocacy groups, and industry participants, to better understand these issues.

Commenters have also expressed their views on the effects of the DOL Fiduciary Rule and the related PTEs—both in terms of benefits and drawbacks—on brokerage advice relationships, at least with respect to retirement advice. Among other things, some commenters asserted that, because of complex and burdensome requirements imposed as part of the BIC Exemption, and the associated litigation risk, broker-dealers are changing the types of products and accounts offered to retirement investors, and focusing on products or accounts with compliance-friendly fee structures, such as level fees or lower-cost products (e.g., eliminating the provision of advice in IRA brokerage accounts and shifting these accounts to asset-based accounts).<sup>74</sup> Commenters expressed concerns that retirement investors will be harmed through reduced product choice, increased cost for retirement advice (if shifted to fee-based arrangements that may be more costly for buy-and-hold investors, or if there are increases in account minimums for commission-based accounts), or lost or restricted access to advice (if investors have small account balances or cannot otherwise afford a fee-based arrangement or the increased cost of a commission-based account).<sup>75</sup>

retail customers, as contemplated by Section 913. . . . is of critical importance and long overdue.”); PIABA Letter (“The lack of a uniform standard of conduct creates a discrepancy between the law and investors’ reasonable expectations.”); Letter from Barbara Novick, Vice Chairman, and Nicole Rosser, Vice President, BlackRock, Inc. (Aug. 7, 2017) (“BlackRock Letter”) (supporting a best interest standard that applies to all types of retail accounts); Letter from Ronald J. Kruszewski, Chairman & CEO, Stifel, Nicolaus & Co. (July 25, 2017) (“Stifel Letter”) (supporting a single standard of care applicable to both brokerage and advisory accounts, while recognizing the inherent differences between these relationships); Letter from Christopher Jones, Executive Vice President of Investment Management and Chief Investment Officer, Financial Engines (Oct. 11, 2017) (“Financial Engines Letter”) (recommending harmonization of the standards applicable to broker-dealers and investment advisers to advance “high-quality, unconflicted advice”); Letter from Gretchen Cepek, Senior Vice President and General Counsel and Stewart D. Gregg, Senior Counsel, Allianz Life Insurance Company of North America (Oct. 13, 2017) (“Allianz Letter”) (supporting a uniform “best interest” standard of conduct applicable to both broker-dealers and investment advisers providing services to retail investors).

<sup>74</sup> See, e.g., BlackRock Letter; ICI August 2017 Letter.

<sup>75</sup> See, e.g., Letter from Kevin Carroll, Managing Director and Associate General Counsel, SIFMA (July 21, 2017) (“SIFMA 2017 Letter”) (stating that

Transaction Exemption 2016–02); Prohibited Transaction Exemptions 75–1, 77–4, 80–83, 83–1, 84–24 and 86–128 Proposed Rule, 82 FR 16902, (Apr. 7, 2017) (“DOL April Extension”), available at <https://www.gpo.gov/fdsys/pkg/FR-2017-04-07/pdf/2017-06914.pdf>. But see *Chamber of Commerce of the U.S.A., et. al. v. U.S. Dep’t of Labor, et. al.*, No. 17–10238 (5th Cir. Mar. 15, 2018).

<sup>66</sup> See DOL November Extension.

<sup>67</sup> *Id.*

<sup>68</sup> Chairman Jay Clayton, *Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers* (June 1, 2017) (“Chairman Clayton Statement”), available at <https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31>.

<sup>69</sup> See Chairman Clayton Statement.

<sup>70</sup> See, e.g., Letter from Dan Pisenti, Whitehall-Parker Securities, Inc. (July 7, 2017) (“Whitehall Letter”) (arguing that the suitability standard is highly effective and no further government intervention is necessary); Letter from Kevin Dunnigan (July 5, 2017) (stating that the DOL Fiduciary Rule is government overreach and consumers should be able to decide what to purchase).

<sup>71</sup> See, e.g., Letter from Herb W. Morgan (June 2, 2017) (stating that a more effective solution would be a simpler one, including increasing penalties and enforcement and requiring full fee disclosure);

Other commenters have noted, however, that such outcomes are not mandated by the DOL Fiduciary Rule, any market disruptions will be addressed by the market, and overall, the adjustment to the DOL Fiduciary Rule has been positive for retirement investors, as the rule has resulted in lower fees, advice in the best interest, and minimized conflicts in advice provided to individuals,<sup>76</sup> including, for example, the development of new product offerings such as “clean shares” that do not have any sales loads, charges or other asset-based fee for sales or distribution.<sup>77</sup>

### B. General Objectives of Proposed Approach

In developing this proposal, we considered the variety of products and services, including the types of advice, that broker-dealers provide to investors; the characteristics of investors who utilize brokerage services; the associated cost and relative affordability of such services; the embedded compensation conflicts associated with these products and services; and the potential impact of such conflicts on investor outcomes (such as evidence suggestive that the failure to apply a “best interest” obligation to conflicted advice has resulted in investor harm).<sup>78</sup> We also considered the regulatory landscape applicable to broker-dealers under the Exchange Act and SRO rules and the investor protections provided when broker-dealers recommend securities transactions or investment strategies to retail customers, and any differences between those protections provided for

the impact of the new DOL Fiduciary Rule has been to significantly shift IRAs from brokerage accounts to advisory accounts, from personal service to call centers or the internet, and to limit the products and fee arrangements available to IRAs); BlackRock Letter (stating that some financial services firms have indicated that they would not offer or would limit IRA brokerage platforms because of the compliance complexities of the BIC Exemption provisions that would go into effect on January 1, 2018 [now delayed until July, 2019], as well as the risk of class action); ICI August 2017 Letter (stating that the DOL Fiduciary Rule and related exemptions is “limiting retirement savers’ choices, restricting their access to information they need for retirement planning, and increasing costs, particularly for those savers who can least afford it”); Letter from Dave Paulsen, Executive Vice President and Chief Distribution Officer, Transamerica (Nov. 20, 2017) (“[A]s a result of the DOL Rule, many broker-dealers are no longer selling variable annuities in an IRA, but continue to sell variable annuities to retail investors.”).

<sup>76</sup> See, e.g., AARP Letter.

<sup>77</sup> See *id.* See also Letter from AFL-CIO, AFSCME, Alliance for Retired Americans, et al. (Aug. 21, 2017) (“AFL-CIO Letter”); Letter from Aron Szapiro, Director of Policy Research, Morningstar, Inc. (Sept. 11, 2017) (“Morningstar Letter”).

<sup>78</sup> See, e.g., Economic Policy Institute Letter; CFA 2017 Letter; IAC Recommendation.

broker-dealer services under other regulatory regimes, particularly those that would exist under the DOL Fiduciary Rule and the BIC Exemption.

We also considered retail customer confusion about the obligations broker-dealers owe when making recommendations and how that confusion may ultimately translate into or exacerbate the potential for investor harm (such as through a misalignment of investor expectations regarding the level of protection received and the level of protection actually provided).<sup>79</sup> We also recognized the importance of providing, to the extent possible, clear, understandable, and consistent standards for brokerage recommendations across a brokerage relationship (*i.e.*, for both retirement and non-retirement purposes) and better aligning this standard with other advice relationships (*e.g.*, a relationship with an investment adviser).<sup>80</sup> We also sought to preserve—to the extent possible—investor choice and access to existing products, services, service providers, and payment options. We sought to avoid a lack of clarity or consistency in the applicable standards and a lack of coordination among regulators, which could ultimately undermine investor choice and access and create legal uncertainty in developing effective compliance programs.

At the same time, we are sensitive to the potential risk that any additional regulatory burdens may cause investors

<sup>79</sup> *Id.*

<sup>80</sup> See, e.g., Letter from Richard Foster, Senior Vice President and Senior Counsel for Regulatory and Legal Affairs, Financial Services Roundtable (Oct. 17, 2017) (“FSR Letter”) (“FSR strongly believes a single standard for broker-dealers servicing both retirement and non-retirement assets is in the best interest of retail customers, because it would reduce customer confusion and ultimately provide customers a higher-level of service. A single standard also would avoid the cost of developing and implementing compliance and supervisory programs around different standards of conduct.”); Morningstar Letter (“Morningstar believes that investors’ confusion about standards of conduct applicable to different kinds of relationships is likely to continue for some time, and disclosures alone will not clarify those standards for many investors. . . . Further, even among experienced investors who hold investments outside of retirement accounts, most investors do not understand the distinctions between broker-dealers and Registered Investment Advisors and the conflicts of interest some financial advisors may have when recommending investments”); TIAA Letter (“Investors should understand the standards of conduct that apply to the financial advisers who give them advice—but today’s disparate standards can easily lead to investor confusion.”); IAA Letter (“An equally stringent standard is also necessary to reduce confusion for investors and ensure that they do not bear the burden of having uncertainty about the standard of conduct that applies to the investment professional they choose.”); PIABA Letter.

to lose choice and access to products, services, service providers, and payment options.<sup>81</sup> In particular, we sought to preserve the ability of investors to pay for advice in the form of brokerage commissions. Various commenters asserted that the commission-based model may be more appropriate for many investors,<sup>82</sup> and we believe that such investors may prefer a commission-based brokerage

<sup>81</sup> See, e.g., SIFMA 2017 Letter; BlackRock Letter; ICI August 2017 Letter; Franklin Templeton Letter (“[W]hile asset-based fees are appropriate in many circumstances, for some investors—such as long-term, ‘buy-and-hold’ investors—a transaction-based charge can result in substantial savings. According to the Investment Company Institute, investors who plan to hold fund shares for longer than five years would end up with a higher account balance under a commission-based approach that charges a 2.5 percent front-end fee (plus an ongoing 12b-1 fee) than investors paying a 1 percent per year asset-based fee.”)

<sup>82</sup> See, e.g., USAA Letter (“USAA has deep reservations about any standard of conduct that serves to advantage fee-based accounts and serves to disadvantage other types of accounts and product choices. Put simply, a fee-based model may not always be appropriate for lower-balanced accounts. In many cases, these accounts will be better served by straight-forward investments in mutual funds or exchange-traded funds, without such accounts being assessed an ongoing management fee.”); Letter from Stephen McManus, Senior Vice President and General Counsel, State Farm Mutual Automobile Insurance Company (Aug. 21, 2017) (“State Farm Letter”) (“Long a mainstay of the financial services industry, sales commissions are frequently preferred by middle-income consumers whose ‘buy-and-hold’ strategy does not require the continuous investment advice that is more suited to a percentage fee based on assets under management. This preference also reflects the fact that the payment of commission-based compensation—tied as it is to a particular transaction—is easy for consumers to understand and, in *e.g.*, many cases, represents good value for smaller or low-volume accounts.”). See Letter from Sharon Cheever, Senior Vice President and General Counsel, Pacific Life Insurance Company (Oct. 16, 2017) (“Pacific Life Letter”) (“There is a common misconception that a fee-based compensation model is somehow better for the consumer, in part, because it is allegedly cheaper and less likely to lead to conflicts of interest. This unfair discrimination against the commission-based compensation model is truly unfounded. The expense to the client in terms of actual money paid on an on-going basis, and thus, ‘fee-drag’ on their investment return, will often be more with the fee-based compensation model. For example, annuities by nature are long-term investments, and with the fee-based compensation model, the adviser charges a certain percentage (1%) or dollar amount each year for the management of the investment. Compare this to the commission-based compensation model, where there is typically a larger percentage charged upfront (*e.g.*, 5–6%), and you can see that the longer term the investment, the more expensive a fee-based compensation model can be for the client.”); Carl B. Wilkerson, Vice President and Chief Counsel, Securities & Litigation, American Council of Life Insurers (Oct. 3, 2017) (“ACLI Letter”) (“Recurrent annual fees may be ill-suited to individuals with moderate assets needing little annual advice, and may exceed the total value of a commissioned-based adviser.”). See also FINRA Notice to Members 03–68, Fee-Based Compensation (Nov. 2003).

relationship over a fee-based account.<sup>83</sup> We also share concerns raised by commenters about retail customers losing access to advice they receive through recommendations from broker-dealers, or if advice from broker-dealers is effectively eliminated, particularly as not all such customers have the option to move to fee-based accounts.<sup>84</sup>

After extensive consideration of these issues, we are proposing to enhance existing broker-dealer conduct obligations when they make recommendations to a retail customer. For such recommendations, the proposed rule would require a broker-dealer “to act in the best interest of the retail customer . . . without placing the financial or other interest of the [broker-dealer] making the recommendation ahead of the interest of the retail customer.”

The proposed best interest obligation for broker-dealers set forth in Regulation Best Interest builds upon, and is tailored to, existing broker-dealer relationships and regulatory obligations under the federal securities laws and SRO rules. In particular, the existing rules of various SROs served as an important point of reference for our proposal. However, we tailored and enhanced these requirements to the specific proposed best interest obligation we are seeking to establish. Our proposal also takes into

consideration and draws on (to the extent appropriate) the principles of the obligations that apply to investment advice in other contexts, including those described above. We preliminarily believe it makes more sense to build upon this regulatory regime, rather than to create a completely new standard or simply adopt obligations and duties that have developed under a separate regulatory regime to address a different type of advice relationship.

We believe this approach would have several benefits. First, it would enhance the quality of recommendations provided by broker-dealers to retail customers. Second, it would enhance disclosure, helping retail customers evaluate recommendations received from broker-dealers, and reducing confusion regarding the nature of the broker-dealer relationship. Third, it would facilitate more consistent regulation of similar activity, drawing from key principles underlying the fiduciary obligations that apply to investment advice in other contexts. Fourth, it would better align the legal obligations of broker-dealers with investors’ expectations.

We also believe that the best interest obligation we are proposing today would help preserve investor choice and access to affordable investment advice and products that investors currently use. As discussed below, Regulation Best Interest would only apply when a broker-dealer is making a recommendation to a retail customer about a securities transaction or an investment strategy involving securities. The regulation would not apply to the provision of services that do not involve or are distinct from such a recommendation, including, but not limited to, executing an unsolicited transaction for a retail customer, or to a broker-dealer that is dually-registered as an investment adviser (a “dual-registrant”) when making a recommendation in its investment adviser capacity.<sup>85</sup> In this way, our proposed best interest obligation should enhance investor protection while generally preserving (to the extent possible) the range of choice and access—both in terms of services and products—that is available to brokerage customers today.

We recognize that as a result of the enhanced obligations that would apply, some broker-dealers may determine that it is not cost-effective to continue to recommend certain products or services to retail customers (because, for example, of the difficulty in mitigating certain compensation related conflicts).

Others may pass along the costs to retail customers. Some retail customers may seek out a different advice relationship that better suits their preferences after receiving the required disclosures. As discussed in more detail in Section IV, we preliminarily believe that any such impacts that the proposed regulatory changes may have on retail customer access to and availability of investment advice, and the costs to broker-dealers, would be justified by the benefits of the enhancements to investor protection. We also believe that for both retail customers and broker-dealers the potential costs would be less—and the benefits would be greater—than under the potential regulatory alternatives we considered.<sup>86</sup>

In proposing Regulation Best Interest, we are not proposing to amend or eliminate existing broker-dealer obligations, and compliance with Regulation Best Interest would not alter a broker-dealer’s obligations under the general antifraud provisions of the federal securities laws. Regulation Best Interest applies in addition to any obligations under the Exchange Act, along with any rules the Commission may adopt thereunder, and any other applicable provisions of the federal securities laws and related rules and regulations.<sup>87</sup> Furthermore, we do not believe proposed Regulation Best Interest would create any new private right of action or right of rescission, nor do we intend such a result.<sup>88</sup>

Scienter would not be required to establish a violation of Regulation Best Interest. One key difference and enhancement resulting from the obligations imposed by Regulation Best Interest as compared to a broker-dealer’s existing suitability obligations under the antifraud provisions of the federal securities laws, is that a broker-dealer would not be able to satisfy its Care Obligation discussed in Section D.2 through disclosure alone.

Similarly, the existing rules of various SROs served as an important point of reference for our proposal. However, we tailored and enhanced these existing

<sup>83</sup> See Foy, Michael, “What’s at stake for forward-thinking firms,” Fiduciary Roulette, J.D. Power, available at <http://www.jdpower.com/resource/wealth-management-fiduciary-roulette> (visited January 31, 2018) (finding that 59% of investors who currently pay commissions “‘probably would not’ or ‘definitely would not’ stay with their current firm if required to switch to a fee-based arrangement”). Irrespective of any real or perceived investor preference, the last 12 years have seen a decline in the number of broker-dealers from over 6,000 in 2005 to less than 4,000 in 2016, alongside a simultaneous increase in the number of Commission-registered investment advisers from approximately 9,000 in 2005 to over 12,000 in 2016. The Commission understands that firms have transitioned to fee-based retail business in an effort to, among other things, provide stability, increase profitability, lower perceived regulatory burden, provide more or better services to retail investors, and reduce or eliminate conflicts of interest. See discussion Section IV.C.1.c, *infra*.

<sup>84</sup> See *supra* note 74; see also USAA Letter (“It is critical that a uniform standard does not impose excessive legal and compliance burdens on such firms, which would effectively incent firms to curtail or even close services to these investors. A standard that effectively bans or incents firms to abandon certain business models will harm retail investors, especially our men and women in uniform, by raising their costs, reducing their choices, and restricting their access to needed investment advice.”); Franklin Templeton Letter (“At the same time, broker-dealers should not be subject to overly prescriptive requirements or to enforcement through private litigation from the professional plaintiff’s bar. This will only lead to additional costs and a decrease in the availability of investment choices and advice to those retail investors who need it most.”).

<sup>85</sup> See *infra* Section II.C.4. for further discussion.

<sup>86</sup> See Section IV.

<sup>87</sup> For example, any transaction or series of transactions, whether or not subject to the provisions of Regulation Best Interest, remain subject to the antifraud and anti-manipulation provisions of the securities laws, including, without limitation, Section 17(a) of the Securities Act of 1933 (“Securities Act”) [15 U.S.C. 77q(a)] and Sections 9, 10(b), and 15(c) of the Exchange Act [15 U.S.C. 78i, 78j(b), and 78o(c)] and the rules thereunder.

<sup>88</sup> Regulation Best Interest is being proposed, in part, pursuant to the authority provided by Section 913(f) of the Dodd-Frank Act and Section 15(l) of the Exchange Act. Neither Section 913(f) nor Section 15(l), by its terms, creates a new private right of action or right of rescission.

SRO requirements to the specific proposed best interest obligation we were seeking to establish. As a result, we recognize that there may be overlapping regulatory requirements applicable to the same activity. We are mindful of potential regulatory conflicts or redundancies and have sought in proposing Regulation Best Interest to avoid such conflicts and minimize redundancies, but consistent with our goal of establishing a best interest obligation for broker-dealers. Overall, we believe that proposed Regulation Best Interest is generally designed to be consistent with and build upon the relevant SRO requirements.<sup>89</sup>

We wish to underscore that proposed Regulation Best Interest focuses on specific enhancements to the broker-dealer regulatory regime, in light of the unique characteristics of the brokerage advice relationship and associated services that may be provided, and therefore would be separate and distinct from the fiduciary duty that has developed under the Advisers Act. Further, we do not intend that Regulation Best Interest, including the associated obligations, have any impact on the Commission's or its staff's interpretations of the scope or nature of an investment adviser's fiduciary obligations.<sup>90</sup>

## II. Discussion of Regulation Best Interest

### A. Overview of Regulation Best Interest

The Commission is proposing a new rule, referred to as Regulation Best Interest, to establish an express best interest obligation that would apply to broker-dealers when making a recommendation of any securities transaction or investment strategy to a retail customer. The proposed best interest obligation, which is set forth in proposed paragraph (a)(1), would require a broker-dealer, when making a

<sup>89</sup> Generally, when a requirement of proposed Regulation Best Interest is based on a similar SRO standard, we would expect—at least as an initial matter—to take into account the SRO's interpretation and enforcement of its standard when we interpret and enforce our rule. At the same time, we would not be bound by an SRO's interpretation and enforcement of an SRO rule, and our policy objectives and judgments may diverge from those of a particular SRO. Accordingly, we would also expect to take into account such differences in interpreting and enforcing our rules. We have taken the same approach in other rulemakings that include requirements based on a similar SRO standard. *See, e.g.*, Exchange Act Release No. 77617 (Apr. 14, 2016), 81 FR 29960, 29997 (May 13, 2016) (“Business Conduct Standards Adopting Release”).

<sup>90</sup> *See* Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Release No. IA-4889, File No. S7-09-18 (“Fiduciary Duty Interpretive Release”).

recommendation, “to 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, or a natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.” Regulation Best Interest would specifically provide that this best interest obligation shall be satisfied if:

- The broker, dealer or natural person who is an associated person of a broker or dealer, prior to or at the time of the recommendation, reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest that are associated with the recommendation (the “Disclosure Obligation”);

- The broker, dealer or natural person who is an associated person of a broker or dealer, in making the recommendation, exercises reasonable diligence, care, skill, and prudence to: (1) Understand the potential risks and rewards 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; (2) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on the retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (3) have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best 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 (herein, “Care Obligation”);

- The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with recommendations; and

- The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations (the last two together, the “Conflict of Interest Obligations”).

We preliminarily believe that establishing an express best interest obligation and defining it in this manner would enhance the quality of recommendations provided, and would

align broker-dealers' obligations more closely with retail customers' reasonable expectations.<sup>91</sup> The best interest obligation, including the specific component obligations, that we are proposing today would address certain conflicted recommendations and set a clear minimum standard for broker-dealer conduct. Specifically, we believe that it would improve investor protection and the regulation of broker-dealer recommendations in four key ways.

First, it fosters retail customer awareness and understanding by requiring disclosure of the material facts relating to the scope and terms of the relationship with the retail customer.

Second, it is designed to enhance provisions under the federal securities laws relating to the quality of broker-dealer recommendations by establishing an express Care Obligation that sets forth minimum professional standards that encompass and go beyond existing suitability obligations under the federal securities laws, and could not be satisfied through disclosure alone.<sup>92</sup>

Third, it enhances the disclosure of material conflicts of interest. This would help educate retail customers about those conflicts, and help them evaluate recommendations received from broker-dealers.

Fourth, it establishes obligations that require mitigation, and not just disclosure, of conflicts of interest arising from financial incentives associated with the recommendation (such as compensation incentives, incentives to recommend proprietary products, and incentives to effect transactions in a principal capacity).

Taken together, we preliminarily believe these enhancements will improve investor protection by minimizing the potential harmful impacts that broker-dealer conflicts of interest may have on recommendations provided to retail customers. Furthermore, it is our understanding that many broker-dealers support the establishment of a best interest standard.<sup>93</sup>

As discussed in more detail below, in developing proposed Regulation Best Interest, the Commission has drawn from principles that apply to investment advice under other regulatory regimes—most notably SRO rules, state common law, the Advisers Act, and any duties that would apply to broker-dealers as a

<sup>91</sup> *See, e.g.*, Letter from David Certner, Legislative Counsel & Legislative Policy Director, Government Affairs, AARP (Sept. 6, 2017) (“AARP”) (“Investors expect financial intermediaries to be required to act in their (the customer's) best interest.”).

<sup>92</sup> *See supra* note 7.

<sup>93</sup> *See, e.g.*, SIFMA 2017 Letter.

result of the DOL Fiduciary Rule and the related PTEs (most notably, the BIC Exemption)—with the goal of both establishing greater consistency in the level of protection provided across registered investment advice relationships (while having the specific regulatory obligations for broker-dealers and investment advisers reflect the structure and characteristics of their relationships with retail customers) and easing compliance with Regulation Best Interest where these other overlapping regulatory regimes are also applicable.

In particular, as a threshold matter, it is worth noting that, in determining how to frame proposed best interest obligation, we considered the “best interest” standards outlined in other contexts, in particular the standard set forth in Section 913(g) of the Dodd-Frank Act<sup>94</sup> and the 913 Study recommendation,<sup>95</sup> as well as the DOL’s “best interest” Impartial Conduct Standard, even though we are not proposing a uniform fiduciary standard under Section 913(g).<sup>96</sup> Our proposed definition differs from the wording of these standards by replacing the phrase “without regard to the financial or other interest” with the phrase “without placing the financial or other interest . . . ahead of the interest of the retail customer.” We are proposing this change as we are concerned that inclusion of the “without regard to” language could be inappropriately construed to require a broker-dealer to eliminate all of its conflicts (*i.e.*, require

recommendations that are conflict free),<sup>97</sup> and we believe that our proposed formulation appropriately reflects what we believe is the underlying intent of the “without regard to . . .” formulation.

We understand that, like other investment firms, broker-dealers have conflicts of interest, in particular financial interests, when recommending transactions to retail customers. Certain conflicts of interest are inherent in any principal-agent relationship. We do not intend for our standard to prohibit a broker-dealer from having conflicts when making a recommendation. Nor do we believe that is the intent behind the “without regard to” phrase, as included in Section 913 of the Dodd-Frank Act or recommended in the 913 Study, as is evident both from other provisions of Section 913 that acknowledge and permit the existence of financial interests under that standard, and how our staff articulated the recommended uniform fiduciary standard.<sup>98</sup> Among other things, Dodd-Frank Act Section 913(g) expressly provides that the receipt of commission-based compensation, or other standard compensation, for the sale of securities shall not, in and of itself, violate any uniform fiduciary standard promulgated under that subsection’s authority as applied to a broker-dealer.<sup>99</sup> Moreover, Section 913(g) does not itself require the imposition of the principal trade provisions of Advisers Act Section 206(3) on broker-dealers.<sup>100</sup> In addition, Dodd-Frank Act Section 913 provides that offering only proprietary products by a broker-dealer shall not, in and of itself, violate such a uniform fiduciary standard, but may be subject to

disclosure and consent requirements.<sup>101</sup> We believe that these provisions make clear that the overall intent of Section 913 was that a “without regard to” standard did not prohibit, mandate or promote particular types of products or business models, and preserved investor choice among such services and products and how to pay for these services and products (*e.g.*, by preserving commission-based accounts, episodic advice, principal trading and the ability to offer only proprietary products to customers).<sup>102</sup>

In lieu of adopting wording that embodies apparent tensions, we are proposing to resolve those tensions through another formulation that appropriately reflects what we believe is the underlying intent of Section 913: That a broker-dealer should not put its interests ahead of the retail customer’s interests when making a recommendation to a retail customer. In other words, the broker-dealer’s financial interest can and will inevitably exist, but these interests cannot be the predominant motivating factor behind the recommendation. Our proposed language makes this intention clear by stating a broker-dealer and its associated persons are not to put their interests ahead of the retail customer’s interests. We request comment below, however, on whether our proposed rule should instead incorporate the “without regard to” language set forth in Section 913 and the 913 Study recommendation, which we believe would also generally correspond to the DOL’s language in the BIC Exemption, but interpret that phrase in the same manner as the “without placing the financial or other interest . . . ahead of the interest of the retail customer” approach set forth above.

We also appreciate the desire for clarity regarding the interpretation of our proposed best interest obligation. In the discussion that follows, we are addressing these concerns by providing clarity about the requirements imposed by the proposed best interest obligation, and offering guidance on how a broker-dealer could comply with these requirements.

Specifically, to provide assistance to broker-dealers complying with the requirements of Regulation Best Interest, the Commission’s proposal: (1) Provides guidance setting forth our preliminary views of what the best interest obligation would require, generally; (2) defines the key terms and scope of the proposed best interest obligation; and (3) specifies by rule the specific components with which a broker-dealer

<sup>94</sup> Pursuant to Section 913(g) of the Dodd-Frank Act, “[t]he Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers . . . shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.” 15 U.S.C. 80b-11(g)(1); 15 U.S.C. 78o(k)(1). Section 913(g) also provides that “[s]uch rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under Sections 206(1) and 206(2) [of the Advisers Act].” *Id.*

<sup>95</sup> See *infra* Section II.D.2.d.2 for a further discussion of how proposed Regulation Best Interest compares to the 913 Study recommendations.

<sup>96</sup> As discussed *supra* note 88, Regulation Best Interest is being proposed, in part, pursuant to the authority provided by Section 913(f) of the Dodd-Frank Act, which provides the Commission discretionary authority to “commence a rulemaking, as necessary or appropriate to the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide), to address the legal or regulatory standards of care for brokers, dealers . . . [and] persons associated with brokers or dealers . . . for providing personalized investment advice about securities to such retail customers.” In doing so, the Commission is required to consider the findings, conclusions and recommendations of the 913 Study.

<sup>97</sup> Some commenters raised similar concerns of potential confusion and uncertainty regarding the expectations associated with including this phrase in the best interest obligation. See, *e.g.*, SIFMA 2017 Letter; T. Rowe Letter; Letter from Jason Chandler, Group Managing Director, Head of Investment Platforms and Solutions Wealth Management Americas, and Micheal Crawl, Group Managing Director, General Counsel, UBS Group Americas and Wealth Management Americas, UBS AG (July 21, 2017) (“UBS Letter”).

Other commenters, however, expressed support for a “best interest” obligation that included that the “without regard to phrase.” See, *e.g.*, Letter from Christine L. Owens, Executive Director, National Employment Law Project (Oct. 20, 2017); PIABA 2017 Letter; Wells Fargo Letter; AARP Letter.

<sup>98</sup> See discussion *infra* Section II.D.2.d.2.

<sup>99</sup> See Exchange Act Section 15(k)(1) and Advisers Act Section 211(g)(1). See also 913 Study at 113.

<sup>100</sup> *Id.* Advisers Act Section 206(3) prohibits an adviser from engaging in a principal trade with an advisory client, unless it discloses to the client in writing before completion of the transaction the capacity in which the adviser is acting and obtains the consent of the client to the transaction.

<sup>101</sup> *Id.*

<sup>102</sup> See 913 Study at 113.

would be required to comply to satisfy its best interest obligation.

### B. Best Interest, Generally

Proposed Regulation Best Interest uses the term “best interest” in several places. Under proposed paragraph (a)(1), broker-dealers would be required to “act in the best interest of the retail customer . . . without placing the financial or other interest of” the broker-dealer making the recommendation “ahead of the interest of the retail customer.” This general requirement would be satisfied through compliance with the four specific components of Regulation Best Interest set forth in paragraph (a)(2): The Disclosure Obligation described in Section II.D.1, the Care Obligation described in Section II.D.2 and the two prongs of the Conflict of Interest Obligations discussed in Section II.D.3. In addition, the term “best interest” is included in the Care Obligation, which would require, among other things, a broker-dealer to “have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers,” to “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 and rewards associated with the recommendation,” and “have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer’s best interest when viewed in isolation, is not excessive and is in the retail customer’s best interest.”

The proposed best interest obligation, as defined by the Disclosure, Care, and Conflict of Interest Obligations below, encompasses and goes beyond a broker-dealer’s existing suitability obligations.<sup>103</sup> As previously noted, one key difference between the Care Obligation imposed by Regulation Best Interest and the suitability obligation derived from the antifraud provisions of the federal securities laws is that the antifraud provisions require an element of fraud or deceit, which would not be required under Regulation Best Interest. More specifically, the Care Obligation could not be satisfied by disclosure. Second, as discussed below, our proposed interpretation of the Care Obligation would make the cost of the security or strategy, and any associated financial incentives, more important factors (of the many factors that should be considered) in understanding and analyzing whether to recommend a security or an investment strategy. Third, beyond the Care Obligation,

Regulation Best Interest imposes Disclosure and Conflict of Interest Obligations that are intended to manage the potential impact that broker-dealer conflicts of interest may have on their recommendations.

We are not proposing to define “best interest” at this time. Instead, we preliminarily believe that whether a broker-dealer acted in the best interest of the retail customer when making a recommendation will turn on the facts and circumstances of the particular recommendation and the particular retail customer, along with the facts and circumstances of how the four specific components of Regulation Best Interest are satisfied. Furthermore, in the discussion below and in our discussion of each of these specific obligations, we provide further guidance regarding our views of how a broker-dealer could act in the best interest of the retail customer, including how a broker-dealer could make a recommendation in the “best interest,” and how it compares to existing broker-dealer obligations.

As a threshold matter, we recognize that it may be in a retail customer’s best interest to allocate investments across a variety of investment products, or to invest in riskier or more costly products. We do not intend to limit through proposed Regulation Best Interest the diversity of products available, the higher cost or risks that may be presented by certain products, or the diversity in retail customers’ portfolios. This proposal is not meant to effectively eliminate recommendations that encourage diversity in a retail customer’s portfolio through investment in a wide range of products, such as actively managed mutual funds, variable annuities, and structured products. We recognize that these and other products that may involve higher risks or cost to the retail customer may be suitable under existing broker-dealer obligations. We believe these products could likewise continue to be recommended under Regulation Best Interest, if the broker-dealer satisfied its obligations under proposed Regulation Best Interest.

Rather, proposed Regulation Best Interest is designed to address the harm associated with broker-dealer incentives to recommend products for reasons that put the broker-dealer’s interest ahead of the customer’s interest (e.g., because of higher compensation or other financial incentives for the broker-dealer). Nevertheless, we are sensitive to the potential that, in order to meet their obligations under the proposed Regulation Best Interest, broker-dealers may, for compliance and business reasons, determine to avoid offering

certain products or limit recommendations to only certain low-cost and low-risk products that would appear on their face to satisfy the proposed best interest obligation. We emphasize that is not the intent of this proposal, and we request comment on the extent to which proposed Regulation Best Interest would result in broker-dealers limiting access to or eliminating certain products in a manner that could, in and of itself, cause harm to certain retail customers for whom those products are consistent with their investment objectives and in their best interest.

Specifically, as further clarification, proposed Regulation Best Interest would not *per se* prohibit a broker-dealer from transactions involving conflicts of interest, such as the following:

- Charging commissions or other transaction-based fees;
- Receiving or providing differential compensation based on the product sold;
- Receiving third-party compensation;
- Recommending proprietary products, products of affiliates or a limited range of products;
- Recommending a security underwritten by the broker-dealer or a broker-dealer affiliate, including initial public offerings (“IPOs”);
- Recommending a transaction to be executed in a principal capacity;
- Recommending complex products;
- Allocating trades and research, including allocating investment opportunities (e.g., IPO allocations or proprietary research or advice) among different types of customers and between retail customers and the broker-dealer’s own account;
- Considering cost to the broker-dealer of effecting the transaction or strategy on behalf of the customer (for example, the effort or cost of buying or selling an illiquid security); or
- Accepting a retail customer’s order that is contrary to the broker-dealer’s recommendations.

While these practices would not be *per se* prohibited by Regulation Best Interest, we are also not saying that these practices are *per se* consistent with Regulation Best Interest or other obligations under the federal securities laws. Rather, these practices, which generally involve conflicts of interest between the broker-dealer and the retail customer, would be permissible under Regulation Best Interest only to the extent that the broker-dealer satisfies the specific requirements of Regulation Best Interest.

While to satisfy proposed Regulation Best Interest, a broker-dealer would not

<sup>103</sup> See discussion *infra* Section II.D.

be required to analyze all possible securities, other products or investment strategies to find the single “best” security or investment strategy for the retail customer, broker-dealers generally should consider reasonably available alternatives offered by the broker-dealer as part of having a reasonable basis for making the recommendation, as required under the Care Obligation. Proposed Regulation Best Interest also would not necessarily obligate a broker-dealer to recommend the “least expensive” or the “least remunerative” security or investment strategy, provided the broker-dealer complies with the Disclosure, Care, and the Conflict of Interest Obligations set forth in the relevant sections below.<sup>104</sup>

As discussed in the Care Obligation below, we believe that the cost (including fees, compensation and other financial incentives) associated with a recommendation would generally be an important factor. However, there are also other factors that a broker-dealer should consider in determining whether a recommendation is in the best interest of a retail customer, as required by the Care Obligation. Other factors that would also be important to this determination include, among others, the product’s or strategy’s investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits,

<sup>104</sup> As noted, *infra* Section II.C.2, Regulation Best Interest is intended to address concerns regarding the impact of material conflicts of interest, and the level of care exercised, when broker-dealers recommend a security or investment strategy involving securities to retail customers. Accordingly, proposed Regulation Best Interest applies only to recommendations, and the care exercised in making a recommendation and addressing the conflicts associated with a recommendation that may impact a broker-dealer’s recommendation of a security or investment strategy, but would not apply to the execution of a recommended transaction or the potential conflicts of interest associated with executing a recommended transaction (e.g., payments for order flow), which as discussed below are addressed by existing broker-dealer best execution, as well as other regulatory obligations. Under the antifraud provisions of the federal securities laws and SRO rules, broker-dealers have a legal duty to seek to obtain best execution of customer orders. See Regulation NMS, Exchange Act Release No. 51808 (June 9, 2005) (“Regulation NMS Release”); FINRA Rule 5310 (Best Execution and Interpositioning). A broker-dealer’s duty of best execution requires a broker-dealer to seek to execute customers’ trades at the most favorable terms reasonably available under the circumstances. See Regulation NMS Release at 160. In addition, Exchange Act Rules 10b–10, 606, and 607 require broker-dealers to disclose information about payment-for-order-flow arrangements to customers at the opening of a new account and, thereafter, on customer trade confirmations and in public quarterly reports. Proposed Regulation Best Interest would be separate from and would not alter these obligations, which apply when a broker-dealer executes a transaction, regardless of whether it was recommended. See *infra* Section II.D.1.d.2.

volatility and likely performance in a variety of market and economic conditions.<sup>105</sup> While cost and financial incentives would generally be important, they may be outweighed by these other factors. Accordingly, we preliminarily believe that a broker-dealer would not satisfy its Care Obligation—and hence Regulation Best Interest—by simply recommending the least expensive or least remunerative security without any further analysis of these other factors and the retail customer’s investment profile.

We preliminarily believe that, in order to meet its Care Obligation, when a broker-dealer recommends a *more expensive* security or investment strategy over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable basis to believe that the higher cost of the security or strategy is justified (and thus nevertheless in the retail customer’s best interest) based on other factors (e.g., the product’s or strategy’s investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions), in light of the retail customer’s investment profile. When a broker-dealer recommends a *more remunerative* security or investment strategy over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable basis to believe that—putting aside the broker-dealer’s financial incentives—the recommendation was in the best interest of the retail customer based on the factors noted above, in light of the retail customer’s investment profile. Nevertheless, this does not mean that a broker-dealer could not recommend the more remunerative of two reasonably available alternatives, if the broker-dealer determines the products are otherwise both in the best interest of—and there is no material difference between them from the perspective of—the retail customer, in light of the retail customer’s investment profile.

We preliminarily believe that under the Care Obligation, a broker-dealer could not have a reasonable basis to believe that a recommended security is in the best interest of a retail customer if it is more costly than a reasonably available alternative offered by the broker-dealer and the characteristics of the securities are otherwise identical, including any special or unusual features, liquidity, risks and potential

benefits, volatility and likely performance.<sup>106</sup> Further, it would be inconsistent with the Care Obligation for the broker-dealer to recommend the more expensive alternative for the customer, even if the broker-dealer had disclosed that the product was higher cost and had policies and procedures in place that were reasonably designed to mitigate the conflict under the Conflict of Interest Obligations, as the broker-dealer would not have complied with its Care Obligation, as the higher cost of the security would not be justified by the security’s other characteristics in comparison to reasonably available alternatives (in contrast to the examples discussed below). By treating cost associated with a recommendation as an important factor in this analysis, the Care Obligation would enhance a broker-dealer’s existing suitability obligations under the federal securities laws.

We believe that a broker-dealer would violate proposed Regulation Best Interest’s Care Obligation and Conflict of Interest Obligations, if any recommendation was predominantly motivated by the broker-dealer’s self-interest (e.g., self-enrichment, self-dealing, or self-promotion), and not the customer’s best interest—in other words, putting aside the broker-dealer’s self-interest, the recommendation is not otherwise in the best interest of the retail customer based on other factors, in light of the retail customer’s investment profile, and as compared to other reasonably available alternatives offered by the broker-dealer. Examples would include making a recommendation to a retail customer in order to: Maximize the broker-dealer’s compensation (e.g., commissions or other fees); further the broker-dealer’s business relationships; satisfy firm sales quotas or other targets; or win a firm-

<sup>106</sup> An example of identical securities with different cost structures are mutual funds with different share classes. The Commission has historically charged broker-dealers with violating Sections 17(a)(2) and (3) of the Securities Act for making recommendations of more expensive mutual fund share classes while omitting material facts. See, e.g., *In re IFG Network Sec., Inc.*, Exchange Act Release No. 54127, at \* 15 (July 11, 2006) (Commission Decision) (registered representative violated Sections 17(a)(2) and (3) by omitting to disclose to his customers material information concerning his compensation and its effect upon returns that made his recommendation that they purchase Class B shares misleading; “The rate of return of an investment is important to a reasonable investor. In the context of multiple-share-class mutual funds, in which the only bases for the differences in rate of return between classes are the cost structures of investments in the two classes, information about this cost structure would accordingly be important to a reasonable investor.”).

<sup>105</sup> See discussion *infra* Section II.D.1.

sponsored sales contest.<sup>107</sup> We discuss possible methods of compliance with the Care Obligation and mitigation requirement in Section II.D. below.

On the other hand, the best interest obligation would allow a broker-dealer to recommend products that may entail higher costs or risks for the retail customer, or that may result in greater compensation to the broker-dealer than other products, or that may be more expensive, provided that the broker-dealer complies with the specific Disclosure, Care, and Conflict of Interest Obligations described in Section II.D.

## 1. Consistency With Other Approaches

### a. DOL Fiduciary Rule and Related PTEs

We believe that the principles underlying our proposed best interest obligation as discussed above, and the specific Disclosure, Care, and Conflict of Interest Obligations described in more detail below, generally draw from underlying principles similar to the principles underlying the DOL's best interest standard, as described by the DOL in the BIC Exemption.<sup>108</sup> By choosing language that draws on similar principles to the principles underlying the DOL's "best interest" Impartial Conduct Standard, which would currently apply to broker-dealers relying on the BIC Exemption and or any of the related PTEs, we believe our proposed best interest standard would result in efficiencies for broker-dealers that have already established infrastructure to comply with the DOL best interest Impartial Conduct Standard. As we believe that at its core, the Best Interest Obligation is intended to achieve the same purpose as the best interest Impartial Conduct Standard, we preliminarily believe broker-dealers would be able to use the established infrastructure to meet any new obligations.

Under the DOL's standard, we understand that a recommendation could not be based on a broker-dealer's own financial interest in the transaction, nor could a broker-dealer recommend the investment unless it meets the objective prudent person standard of

care.<sup>109</sup> As a general example, the DOL explained that under this standard, an adviser (such as a broker-dealer's registered representative), in choosing between two investments, could not select an investment because it is better for the adviser's bottom line even if it is a worse choice for the investor.<sup>110</sup>

Further, the proposed Disclosure Obligation, Care Obligation and Conflict of Interest Obligations described in more detail below, establish standards of professional conduct that, among other things, would require the broker-dealer to employ reasonable care when making a recommendation. According to the DOL, the BIC Exemption's best interest standard incorporates "objective standards of care and undivided loyalty" that would require adherence to a professional standard of care in making investment recommendations that are in the investor's best interest, and not basing recommendations on the advice-giver's own financial interest in the transaction, nor recommending an investment unless it meets the objective prudent person standard of care.<sup>111</sup>

Like our proposed best interest obligation, we understand that the DOL best interest standard as set forth in the BIC Exemption and in related PTEs, among other things, does not: Prohibit a broker-dealer from being paid, or receiving commissions or other transaction-based payments;<sup>112</sup> prohibit a broker-dealer from restricting recommendations in whole or in part to proprietary products and/or products that generate third-party payments<sup>113</sup> or engaging in "riskless principal transactions"<sup>114</sup> or certain transactions

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.* at 21028.

<sup>112</sup> *See, e.g.*, BIC Exemption Release, 81 FR at 21032.

<sup>113</sup> We understand, however, that the BIC Exemption provides that a broker-dealer that restricts recommendations, in whole or in part, to proprietary products or investments that generate third-party payments, may rely on the exemption provided (among other conditions) the recommendation is prudent, the fees reasonable, the conflicts disclosed (so that the customer can fairly be said to have knowingly assented to the compensation arrangement), and the conflicts are managed through stringent policies and procedures that keep the focus on the customer's best interest, rather than any competing financial interest. *See* BIC Exemption, Section IV; BIC Exemption Release, 81 FR at 21029, 21052–57.

<sup>114</sup> The BIC Exemption provides exemptive relief (if all applicable conditions are met) for compensation received as part of riskless principal transactions, which are defined as "a transaction in which a Financial Institution, after having received an order from a Retirement Investor to buy or sell an investment product, purchases or sells the same investment product for the Financial Institution's own account to offset the contemporaneous transaction with the Retirement Investor." *See* BIC Exemption Release, 81 FR at 21016, 21064. The

on a principal basis;<sup>115</sup> require the identification of the single "best" investment;<sup>116</sup> nor impose an ongoing monitoring obligation, so long as the conditions under the BIC exemption or other applicable PTEs are satisfied.<sup>117</sup>

We understand that our proposed Regulation Best Interest does not reflect the other Impartial Conduct Standards that the broker-dealer: (1) Make no misleading statements; and (2) receive no more than reasonable compensation. We are not proposing standards similar to these Impartial Conduct Standards because existing broker-dealer obligations under the federal securities laws and SRO rules already prohibit misleading statements and require broker-dealers to receive only fair and reasonable compensation. Specifically, the antifraud provisions of the federal securities laws prohibit broker-dealers from making misleading statements.<sup>118</sup> In addition, FINRA rules address broker-dealers' communications with the public and specifically require broker-dealer communications to be based on principles of fair dealing and good faith and to be fair and balanced.<sup>119</sup> Furthermore, FINRA rules generally require broker-dealer prices for securities and compensation for services to be fair and reasonable taking into consideration all relevant circumstances.<sup>120</sup> For these reasons, we do not believe that including these two components of the DOL's Impartial Conduct Standards would add meaningful additional protections for retail customers. In contrast to proposed

DOL provided a separate exemption for investment advice fiduciaries to engage in principal transactions involving specified investments, but subject to additional protective conditions. *See* Principal Transactions Exemption.

<sup>115</sup> Separate from the BIC Exemption, the DOL granted a new exemption for certain principal transactions, which permits ERISA fiduciaries to sell or purchase certain debt securities and other investments in principal transactions and riskless principal transactions with plans and IRAs under certain conditions. *See* Principal Transactions Exemption. Among other conditions, this exemption requires adherence to Impartial Conduct Standards identical to those in the BIC Exemption, including to provide advice in the "best interest" as defined above, with the exception that the Principal Transactions Exemption specifically refers to the fiduciary's obligation to seek to obtain the best execution reasonably available under the circumstances with respect to the transaction, rather than to receive no more than "reasonable compensation." *See id.*

<sup>116</sup> BIC Exemption Release, 81 FR at 21029.

<sup>117</sup> *Id.*

<sup>118</sup> *See, e.g.*, Exchange Act Sections 10(b) and 15(c).

<sup>119</sup> *See* FINRA Rule 2210 (Communications with the Public).

<sup>120</sup> *See, e.g.*, FINRA Rules 2121 (Fair Prices and Commissions), 2122 (Charges for Services Performed), and 2341 (Investment Company Securities). *See also* Exchange Act Sections 10(b) and 15(c).

<sup>107</sup> *See infra* note 321 and accompanying text.

<sup>108</sup> The BIC Exemption's best interest Impartial Conduct Standard would require (as here relevant) that advice be in a retirement investor's best interest, and further defines advice to be in the "best interest" if the person providing the advice acts "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with the such matters would use . . . without regard to the financial or other interests" of the person. BIC Exemption Release, 81 FR at 21007, 21027. BIC Exemption Section II(c)(1); Section VIII(d).



Regulation Best Interest, which would add enhancements to existing broker-dealer obligations, we believe proposing new rules addressing areas already covered by the federal securities laws and SRO rules—without also enhancing those obligations—may cause confusion about how these new obligations would differ from current requirements.

#### b. Recommendations of 913 Study

Our proposed Regulation Best Interest diverges from the recommendation of the 913 Study, in that it does not propose to establish a uniform fiduciary standard of conduct for both investment advisers and broker-dealers, but rather focuses on establishing a best interest obligation for broker-dealers.<sup>121</sup> The 913 Study recommended that the Commission consider rulemakings that would apply expressly and uniformly to both broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers, a fiduciary standard no less stringent than currently applied to investment advisers under Advisers Act Sections 206(1) and (2), which the staff interpreted “to include at a minimum, the duties of loyalty and care as interpreted and developed under Advisers Act Section 206(1) and 206(2).” Specifically, the 913 Study recommended that the Commission should establish a uniform fiduciary standard of conduct requiring broker-dealers and investment advisers, “when providing personalized investment advice about securities to retail customers . . . to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.” Further, the Study recommended that the Commission engage in rulemaking and/or issue interpretive guidance addressing the components of the uniform fiduciary standard: The duties of loyalty (*e.g.*, disclosure and potentially prohibition and mitigation of certain conflicts) and care (*e.g.*, suitability).<sup>122</sup>

<sup>121</sup> We note that proposed Regulation Best Interest only addresses issues related to the 913 Study’s recommendations regarding a standard of conduct for broker-dealers, and does not involve unrelated recommendations of the 913 Study, notably, the recommendations relating to harmonization of the legal frameworks governing broker-dealers and investment advisers more generally. See 913 Study at 129 *et seq.* In a separate concurrent release, we request comment on whether there should be certain potential enhancements to investment advisers’ legal obligations by looking to areas where the current broker-dealer framework provides investor protections that may not have counterparts in the investment adviser context. See Fiduciary Duty Interpretive Release.

<sup>122</sup> See generally 913 Study at 110–23.

We have given extensive consideration to the 913 Study recommendation related to a uniform fiduciary standard of conduct, the information that the public has submitted over the years following the 913 Study, and our extensive experience regulating broker-dealers and investment advisers. Based on our evaluation, we have determined at this time to propose a more tailored approach focusing on enhancements to broker-dealer regulation to address our current concerns. We preliminarily believe it makes more sense to build upon this regulatory regime and the underlying expertise, and in this way reflect the unique characteristics of the relationship (*e.g.*, its transaction-based nature, the variety of services the broker-dealer may provide, which may or may not involve advice, and that the broker-dealer may provide services in a principal or agent capacity), rather than to create a new standard out of whole cloth or simply adopt obligations and duties that have developed under a separate regulatory regime to address a different type of advice relationship (*e.g.*, a relationship that exists primarily for the provision of advice about investments, and typically involves portfolio management, often on a discretionary basis<sup>123</sup>).<sup>124</sup>

Nevertheless, the recommendations of the 913 Study were useful to us in evaluating how to specifically enhance investor protection and improve the obligations that apply to broker-dealers when making recommendations to retail customers. While we are not proposing a uniform fiduciary standard, as recommended in the 913 Study, we nevertheless preliminarily believe that the proposed best interest obligation draws from principles underlying and reflects the underlying intent of many of the recommendations of the 913 Study. As a consequence, we also believe the rule draws upon the duties of loyalty and care as interpreted under Section 206(1) and (2) of Advisers Act, even if not the same as the 913 Study recommendations or the duties interpreted under the Advisers Act.<sup>125</sup>

As discussed above, our proposed best interest obligation would generally track key elements of both the language of Section 913 of the Dodd-Frank Act and the 913 Study recommendation for

<sup>123</sup> Many investment advisers manage portfolios for retail investors and exercise investment discretion over the accounts, while others provide advice to non-discretionary accounts, provide financial planning, and sponsor or act as portfolio managers in wrap fee programs. See, *e.g.*, 913 Study.

<sup>124</sup> See discussion *infra* Section II.F.

<sup>125</sup> See Fiduciary Duty Interpretive Release.

the wording of a uniform fiduciary standard (with the exception of the proposed replacement of “without regard to” language), and would reflect the principles underlying the 913 Study recommendations related to a uniform fiduciary standard of conduct.

Specifically, as noted, the 913 Study recommended that the Commission engage in rulemaking and/or issue interpretive guidance addressing the components of the uniform fiduciary standard: The duties of loyalty (*e.g.*, disclosure and potentially prohibition and mitigation of certain conflicts) and care (*e.g.*, suitability). As discussed in more detail in the relevant sections below, in framing the recommended duties of loyalty and care under the recommended uniform fiduciary standard of conduct, the 913 Study looked to the duties of loyalty and care under the Advisers Act as a baseline for the uniform fiduciary standard—consistent with the “no less stringent” mandate of Section 913(g). For example, in framing the duty of loyalty under the recommended uniform fiduciary standard of conduct, the 913 Study stated that by reference to Advisers Act Section 206(1) and 206(2), the duty of loyalty would require an investment adviser or broker-dealer “to eliminate, or provide full and fair disclosure about its material conflicts of interest.”<sup>126</sup>

Further, taking into consideration the express provisions of Section 913(g) of the Dodd-Frank Act, the 913 Study explains that the recommended uniform standard would neither require the absolute elimination of any particular conflicts (in the absence of another requirement to do so) nor impose on broker-dealers a continuing duty of loyalty or care; nor would the receipt of commissions or other standard compensation, sale of proprietary products, or engaging in transactions on a principal basis, in and of themselves, violate the fiduciary standard.<sup>127</sup> Similarly, in framing the duty of care under the recommended uniform fiduciary standard of conduct, the 913 Study considered the duty of care obligations interpreted under the Advisers Act and current broker-dealer conduct obligations, in recommending that the Commission consider specifying uniform, minimum standards for the duty of care.<sup>128</sup> The 913 Study noted that the Commission could articulate such minimum standards by referring to and expanding upon, as appropriate, the explicit minimum standards of conduct relating to the duty

<sup>126</sup> See 913 Study at 112–13.

<sup>127</sup> See 913 Study at 113.

<sup>128</sup> See 913 Study at 120–21.

of care applicable to broker-dealers (e.g., suitability), and could also take into account Advisers Act principles related to the duty of care (e.g., duty to provide suitable investment advice).<sup>129</sup>

We believe the proposed best interest obligation reflects many of these same principles of what would be required or prohibited under the uniform standard recommended by the 913 Study, as discussed above. In addition, as discussed in Section II.D, consistent with the 913 Study recommendation, to satisfy our proposed best interest obligation, we are proposing that broker-dealers must comply with specific requirements: Namely, the Disclosure, Care and Conflict of Interest Obligations. This specificity is intended to both: (1) Provide clarity to broker-dealers about their obligations under Regulation Best Interest generally and how they relate to existing obligations when making recommendations (i.e., suitability); and (2) particularly address the material conflicts of interest resulting from financial incentives. As we discuss in more detail in the relevant sections specifically addressing these obligations, we believe the Disclosure, Care and Conflict of Interest Obligations generally draw from principles underlying the duties of care and loyalty as recommended in the 913 Study,<sup>130</sup> while having the specific regulatory obligations reflect the unique structure and characteristics of broker-dealer relationships with retail customers.

## 2. Request for Comment on the Best Interest Obligation

The Commission requests comment on defining the proposed best interest obligation to require broker-dealers “to act in the best interest of the retail customer . . . without placing the financial or other interest of the [broker-dealer] making the recommendation ahead of the interest of the retail customer,” as well as comment on the application of this standard and the types of practices that would be consistent or inconsistent with this standard.

- Do commenters believe that we should adopt a best interest obligation for broker-dealers?
- Do commenters agree with the general approach of the best interest obligation of building on existing requirements? Are there alternative approaches or additional steps that the Commission should take? If so, what?
- Would the Best Interest Obligation cause a broker-dealer to act in a manner

that is consistent with what a retail customer would reasonably expect from someone who is required to act in their best interest? If so, how? If not, what further steps should the Commission take? Why or why not?

- Does the obligation enhance retail customer protection? If so, how? If not, what further steps should the Commission take? Why or why not?
- Do commenters agree with our assessment of how the Best Interest Obligation compares with the DOL’s best interest Impartial Conduct Standard, as incorporated in the BIC Exemption? Do commenters believe that proposed Regulation Best Interest provides similar protections to the DOL’s best interest Impartial Conduct Standard, as incorporated in the BIC Exemption? If not, what are the differences and what impact would those differences have on retail customers? Do commenters believe it would be desirable to maintain consistency with the DOL requirements and guidance in this area, as set forth in the BIC exemption?
- As discussed herein, we propose that the best interest obligation would require a broker-dealer, when making a recommendation, not to put the interests of a broker-dealer or its associated persons ahead of the retail customer’s interest. Does this formulation meet the Commission’s goal of protecting retail customers and clarifying the standards that apply when broker-dealers are providing advice?
- It is our intent that our proposal would make it clear that, insofar as existing broker-dealer obligations have been interpreted to stand for the principle that broker-dealers may put their own interests ahead of their retail customers’ when making a recommendation, those interpretations would be inconsistent with Regulation Best Interest. Does the rule text achieve this objective? To the extent that it does not, or it does not do so with appropriate clarity and certainty, what changes could be made to the proposed rule? Should we provide a clarifying note?
- To best capture this obligation, we are proposing that a broker-dealer must act in the best interest of the retail customer “without placing the financial or other interest of the [broker-dealer] making the recommendation ahead of the interest of the retail customer.” Do commenters agree with our proposed approach, or should the Commission take an alternative approach, such as provide that to act in the best interest, a broker-dealer must act in the best interest of the retail customer “without regard to the financial or other interest

- of the [broker-dealer] making the recommendation” or “by placing the interest of the retail customer ahead of the broker-dealer”? Why or why not? What practical impact would the inclusion or exclusion of the Commission’s proposed approach or the potential alternative approach have on the obligations of the proposed best interest obligation as described? Will it lead to retail customer confusion? Would courts interpret the standard differently? Is there different language that the Commission should consider?
- Should the Commission provide further guidance on the proposed best interest obligation? Should the guidance be with respect to particular transactions or relationships? If so, please provide examples of scenarios that should be deemed to meet or not meet this standard.
  - Are the guidance and interpretations provided by the Commission appropriate? Should any of it be included in the rule text? Please be specific.
  - Should the Commission define the term “best interest” in the rule text? Should the Commission define “best interest” with respect to particular transactions or relationships? If so, what definitions should the Commission consider and why? What are the advantages and disadvantages of any proposed alternatives in this context? Please explain with specificity what duties any suggested definitions would entail.
  - Do commenters agree with the Commission’s guidance on what practices should not be *per se* prohibited by Regulation Best Interest (provided the terms of the proposed rule are satisfied)? Why or why not? Should any of these practices be *per se* prohibited? Why or why not?
  - Do commenters agree with our view that recommending a more expensive or more remunerative alternative for identical securities would be inconsistent with Regulation Best Interest? Are there any additional practices that the Commission should specifically identify as consistent or inconsistent with Regulation Best Interest? Please identify any such practices and why they should be viewed as consistent or inconsistent with this obligation.
  - Are any changes in Regulation Best Interest necessary to make it clear that broker-dealers who offered a limited scope of products nevertheless can satisfy the standard?
  - Do commenters believe that proposed Regulation Best Interest would result in broker-dealers limiting access to or eliminating certain products in a

<sup>129</sup> See 913 Study at 121.

<sup>130</sup> See *infra* discussion in Section II.D.1 and 2 comparing the Care and Conflict recommendations of the 913 Study.

manner that could, in and of itself, cause harm to certain retail customers for whom those products are consistent with their investment objectives and in their best interest? If so, what products do commenters think would be limited or eliminated? Would any changes in Regulation Best Interest minimize or avoid these outcomes?

- Do commenters believe that our proposed rule is sufficiently clear that a broker-dealer is not required to monitor a retail customer's account as part of its obligations unless specifically contracted for? If not, what modifications should be made to Regulation Best Interest? Do commenters believe that retail customers understand that a broker-dealer is not required to monitor retail customers' accounts? If so, what is the basis for that understanding (e.g., firm disclosures)? What specific obligations do broker-dealers typically take on if they contract to monitor customer accounts?

- Should Regulation Best Interest apply when broker-dealers agree to provide ongoing monitoring of the retail customer's investment for purposes of recommending changes in investments? Why or why not? Alternatively, should broker-dealers who provide ongoing monitoring be considered investment advisers?

- Do commenters agree with the Commission's assessment that no new private right of action or right of rescission is created by Regulation Best Interest?

- Despite the Commission's assertion that Regulation Best Interest is limited to broker-dealers and is not intended to impact the fiduciary obligations under the Advisers Act, do commenters have concerns regarding the potential impact of this best interest obligation on the legal obligations under other standards? If so, what are these concerns? Do commenters have any suggestions on how to provide further clarification on this issue?

- In defining a broker-dealer's obligation when making a recommendation to a retail customer, the Commission is not proposing to impose additional requirements, such as requirements related to the receipt of fair and reasonable compensation or the prohibition against misleading statements that are part of DOL's Impartial Conduct Standards, because broker-dealers already have these obligations. Should the Commission consider incorporating these or other requirements into the proposed rule? If so, what requirements should be added and why? How should those requirements be defined? How would

the suggested requirements be different from current broker-dealer obligations and enhance investor protection? To the extent broker-dealers already have existing obligations related to suggested additional requirements, should the Commission consider modifying the existing broker-dealer regulatory obligations, and if so, how?

- Do commenters agree with our proposed approach of a tailored standard for broker-dealers as opposed to a uniform standard of conduct for both broker-dealers and investment advisers?

- Do commenters believe that we should explicitly adopt FINRA's suitability standard, and then add any desired changed or enhancements to that standard, in order to simplify the best interest obligation? Are there specific benefits or problems with that approach?

### C. Key Terms and Scope of Best Interest Obligation

#### 1. Natural Person Who Is an Associated Person

The Commission proposes to define "natural person who is an associated person" as a natural person who is an associated person as defined under Section 3(a)(18) of the Exchange Act: "any partner, officer, director or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) of this title (other than paragraph 6 thereof)."

In defining in this manner, we intend to require not only the broker-dealer entity, but also individuals that are associated persons of a broker-dealer (e.g., registered representatives) to comply with specified components of Regulation Best Interest when making recommendations, as described below. We have limited the definition only to a "natural person who is an associated person" to avoid the application of Regulation Best Interest to "all associated persons of a broker-dealer," as the latter definition would capture affiliated entities of the broker-dealer and would extend the application of Regulation Best Interest to entities that are not themselves broker-dealers, which are not our intended focus.

#### 2. When Making a Recommendation, at Time Recommendation Is Made

The Commission proposes that Regulation Best Interest would apply when a broker-dealer is making a recommendation about any securities transaction or investment strategy to a retail customer (as defined and discussed below). We believe that by applying Regulation Best Interest to a "recommendation," as that term is currently interpreted under broker-dealer regulation, we would provide clarity to broker-dealers and their retail customers as to when Regulation Best Interest applies and maintain efficiencies for broker-dealers that have already established infrastructures to comply with suitability obligations. Moreover, we believe that taking an approach that is driven by each recommendation would appropriately capture and reflect the various types of advice broker-dealers provide to retail customers, whether on an episodic, periodic, or more frequent basis and help ensure that customers receive the protections that Regulation Best Interest is intended to provide.

The proposed rule relies in part on the statutory authority provided in Section 913(f) of the Dodd-Frank Act, which provides the Commission rulemaking authority to address the standards of care "for providing personalized investment advice about securities to such retail customers."<sup>131</sup> As noted in the 913 Study, Section 913 of the Dodd-Frank Act does not define "personalized investment advice," and the broker-dealer regulatory regime does not use the term "investment advice" but instead focuses on whether a broker-dealer has made a "recommendation."<sup>132</sup> The 913 Study recommended that the definition of "personalized investment advice" should at a minimum encompass the making of a "recommendation" as developed under applicable broker-dealer regulation.<sup>133</sup> Given that proposed Regulation Best Interest is focused on broker-dealer standards of conduct, and recognizing that the term "personalized investment advice" is not used in the broker-dealer regulatory regime, we propose that, consistent with

<sup>131</sup> See Section 913(f) of the Dodd-Frank Act.

<sup>132</sup> See 913 Study at 123–24.

<sup>133</sup> *Id.* at 127. The 913 Study also indicated that beyond that, "the term also could include any other actions or communications that would be considered investment advice about securities under the Advisers Act (such as comparisons of securities or asset allocation strategies), except for 'impersonal investment advice' as developed under the Advisers Act." *Id.* (emphasis in original). As noted below, we are seeking comment on alternative definitions and the scope of the term "recommendation."

broker-dealer regulation and in recognition of the 913 Study recommendation, proposed Regulation Best Interest would apply to a “recommendation,” as discussed below.<sup>134</sup>

#### a. Scope of Recommendation

The Commission believes that the determination of whether a recommendation has been made to a retail customer that triggers the best interest obligation should be interpreted consistent with existing broker-dealer regulation under the federal securities laws and SRO rules, which would provide clarity to broker-dealers and maintain efficiencies for broker-dealers with established infrastructures that already rely on this term.<sup>135</sup> In addition, the Commission believes that whether a recommendation has been made should, also consistent with existing broker-dealer regulation, turn on the facts and circumstances of the particular situation, and therefore, whether a recommendation has taken place is not susceptible to a bright line definition.<sup>136</sup> We believe that the meaning of the term “recommendation” is well-established and familiar to broker-dealers, and we believe that the same meaning should be ascribed to the term in this context. We are concerned that even providing a

<sup>134</sup> See ICI August 2017 Letter (“We note that because we are suggesting a distinct best interest standard of conduct for broker-dealers, and that the FINRA definition of ‘recommendation’ should apply, the term ‘personalized investment advice,’ which the SEC used in its 2013 request for data, would not be applicable, as that term was intended to encompass both ‘recommendations’ under the FINRA rules and ‘investment advice’ under the Advisers Act.”).

<sup>135</sup> See, e.g., FINRA Regulatory Notice 12–25 at Q2 and Q3 (regarding the scope of “recommendation”); see also Michael F. Siegel, Exchange Act Release No. 58737, at \*21–27 (Oct. 6, 2008) (Commission opinion, sustaining NASD findings) (applying FINRA’s guiding principles to determine that a recommendation was made), *aff’d in relevant part*, Siegel v. SEC, 592 F.3d 147 (D.C. Cir. 2010), cert. denied, 560 U.S. 926 (2010); *In re Application of Paul C. Kettler*, Exchange Act Release No. 31354 at 5, n.11 (Oct. 26, 1992). Some commenters agreed that the Commission should use FINRA’s definition and guidance of recommendation in establishing a standard of conduct for broker-dealers. See AFL–CIO Letter (“Because DOL relied on FINRA guidance with regard to what constitutes a recommendation, the SEC could simply adopt that same definition for its own rulemaking purposes”); Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America (Sept. 14, 2017) (“CFA”) (“While the determination of whether a recommendation has been made will always be based on the particular facts and circumstances, FINRA guidelines provide a sound basis for such a definition.”). See also Business Conduct Standards Adopting Release.

<sup>136</sup> This approach to whether a “recommendation” has occurred is consistent with the approach the Commission has taken in other contexts. See Business Conduct Standards Adopting Release at 156.

principles-based definition, which draws upon the principles underlying existing Commission precedent and guidance, may create unnecessary confusion as to whether the language intentionally or unintentionally diverges from existing precedent. As we are not proposing to make any changes to this existing precedent and guidance regarding when a recommendation is made, we preliminarily believe that it is not necessary or appropriate to define it for purposes of the proposed rule.

In determining whether a broker-dealer has made a recommendation, factors that have historically been considered in the context of broker-dealer suitability obligations include whether the communication “reasonably could be viewed as a ‘call to action’” and “reasonably would influence an investor to trade a particular security or group of securities.”<sup>137</sup> The more individually

<sup>137</sup> See FINRA Notice to Members 01–23, Online Suitability (Mar. 19, 2001), and Notice of Filing of Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook, Exchange Act Release No. 62718 (Aug. 13, 2010), 75 FR 51310 (Aug. 19, 2010), as amended, Exchange Act Release No. 62718A (Aug. 20, 2010), 75 FR 52562 (Aug. 26, 2010) (discussing what it means to make a “recommendation”); FINRA Regulatory Notice 11–02, Know Your Customer and Suitability (Jan. 2011) (discussing how to determine the existence of a recommendation), and FINRA Regulatory Notice 12–25 at n.24 (citing FINRA Regulatory Notices discussing principles on determining whether a communication is a “recommendation”). See also Michael F. Siegel, Exchange Act Release No. 58737, at \*11 (Oct. 6, 2008) (Commission opinion, sustaining NASD findings) (applying FINRA principles to facts of case to find a recommendation), *aff’d in relevant part*, Siegel v. SEC, 592 F.3d 147 (D.C. Cir. 2010), cert. denied, 560 U.S. 926 (2010).

The DOL Fiduciary Rule follows a consistent approach in defining a “recommendation” as a “communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the [advice] recipient engage in or refrain from taking a particular course of action.” See DOL Fiduciary Rule Release, 81 FR 20945, 20972 (“The Department, however, as described both here and elsewhere in the preamble, has taken an approach to defining “recommendation” that is consistent with and based on FINRA’s approach”); U.S. Department of Labor, Employee Benefits Security Administration, Conflict of Interest FAQs, Part II—Rule (Jan. 2017) Q1 (discussing what types of communication constitute a “recommendation”), available at <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-2.pdf> (“DOL FAQs Part II”).

We understand concerns have been expressed that the DOL Fiduciary Rule covers a broader range of communications as “fiduciary investment advice.” We are mindful of such concerns and therefore, propose to interpret what is a recommendation consistent with existing guidance under the federal securities laws and SRO rules. See, e.g., Letter from Lisa Bleier, Managing Director & Associate General Counsel, SIFMA in response to DOL’s Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions (Aug. 9, 2017); Letter from Lisa Bleier,

tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a “recommendation.”

Consistent with existing broker-dealer suitability obligations, certain communications under this approach would generally be excluded from the meaning of “recommendation” as long as they do not include (standing alone or in combination with other communications), a recommendation of a particular security or securities. For example, as recognized under existing broker-dealer regulation, excluded communications would include providing general investor education (e.g., a brochure discussing asset allocation strategies) or limited investment analysis tools (e.g., a retirement savings calculator).<sup>138</sup>

Consistent with existing interpretations and guidance of what constitutes a recommendation, the obligation would apply to activity that has been interpreted as “implicit

Managing Director & Associate General Counsel, SIFMA, in response to RIN 1210–AB79; Proposed Delay and Reconsideration of DOL Regulation Redefining the Term “Fiduciary” (Apr. 17, 2017) (expressing concerns regarding the breadth of what is considered fiduciary investment advice under the DOL Fiduciary Rulemaking and advocating for an approach that “would build upon, and fit seamlessly within, the existing and long-standing securities regulatory regime for broker-dealers”).

<sup>138</sup> See FINRA Rule 2111.03 (excluding the following communications from the coverage of Rule 2111 as long as they do not include (standing alone or in combination with other communications) a recommendation of a particular security or securities: (a) General financial and investment information, including (i) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment, (ii) historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices, (iii) effects of inflation, (iv) estimates of future retirement income needs, and (v) an assessment of a customer’s investment profile; (b) Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan; (c) Asset allocation models that are (i) based on generally accepted investment theory, (ii) accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor’s assessment of the asset allocation model or any report generated by such model, and (iii) in compliance with Rule 2214 (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an “investment analysis tool” covered by Rule 2214; and (d) Interactive investment materials that incorporate the above. The DOL takes a similar approach, excluding from the term “recommendation,” among other things, general communications and investment education (including plan information, general financial, investment and retirement information, asset allocation models and interactive investment materials). See 29 CFR 2510.3–21(b); DOL Fiduciary Rule Release, 81 FR 20945, 20971; DOL FAQs Part II; Definition of Recommendation.

recommendations.”<sup>139</sup> For example, certain transactions that a broker-dealer executes on a retail customer’s behalf, even if not separately authorized, have been interpreted as implicit recommendations that can trigger suitability obligations.<sup>140</sup> We propose that, consistent with existing interpretations and guidance of what constitutes a recommendation, as well as Exchange Act and SRO rules addressing broker-dealer regulation of discretionary accounts,<sup>141</sup> the obligation to act in the customer’s best interest should apply consistently to any recommendation, whether through the execution of discretionary transactions (considered to be implicitly recommended) or when making a recommendation to a brokerage customer in a non-discretionary account.<sup>142</sup>

<sup>139</sup> See, e.g., FINRA Regulatory Notice 12–25 at Q3 (regarding the scope of “implicit recommendation”); see also *infra* Section II. F for further discussion.

<sup>140</sup> See, e.g., Rafael Pinchas, 54 SEC. 331, 341 n.22, 1999 SEC LEXIS 1754, at \*20 n.22 (1999) (“Transactions that were not specifically authorized by a client but were executed on the client’s behalf are considered to have been implicitly recommended within the meaning of [FINRA’s suitability rule].”).

<sup>141</sup> The Exchange Act addresses manipulative, deceptive, or fraudulent practices with respect to discretionary accounts. See Exchange Act Rule 15c1–7 (Discretionary Accounts); Exchange Act Section 3(a)(35) (defining when a person exercises “investment discretion” with respect to an account). See also NASD Rule 2510 (Discretionary Accounts) and Incorporated NYSE Rule 408 (Discretionary Power in Customers’ Accounts). These rules address the obligations that apply to members that have discretionary power over a customer’s account, such as the requirement to obtain customer authorization prior to exercising discretion and to conduct supervisory reviews of discretionary accounts. FINRA has adopted additional rules governing discretionary account requirements for specific products and scenarios. See, e.g., FINRA Rule 5121 (Public Offerings of Securities With Conflicts of Interest) (subpart (c) relating to discretionary accounts); FINRA Rule 4512 (Customer Account Information) (subpart (a)(3) relating to discretionary accounts). These rules are in addition to rules, such as FINRA Rule 2111, that apply to any recommendation. See also Section II.F. for a discussion and request for comment regarding broker-dealer exercise of discretion and the extent to which such exercise is “solely incidental” to the conduct of its business as a broker-dealer.

<sup>142</sup> See, e.g., Paul C. Kettler, 51 SEC. 30, 32 n.11, 1992 SEC LEXIS 2750, at \*5 n.11 (1992) (stating that transactions a broker effects for a discretionary account are implicitly recommended). A number of commenters focused on addressing the standard that applied to “non-discretionary” recommendations. See, e.g., SIFMA 2017 Letter (noting that “BDs, on the other hand, provide non-discretionary recommendations. BDs generally cannot trade on their client’s behalf; clients must authorize any transactions” and suggesting that the definition of the term “recommendation” be limited to “non-discretionary recommendations”); T. Rowe Letter (“Given the history, we believe that the SEC’s best path forward would be to focus specifically on updating the standard applicable to non-

b. Duration of Obligation and Effect of Contractual Arrangements/Course of Dealing

Regulation Best Interest would be triggered “when making” a recommendation and a broker-dealer would be required to act in the best interest “at the time the recommendation is made.” The proposed rule is intended to focus the obligation to each particular instance when a recommendation is made to a retail customer and whether the broker-dealer satisfied its best interest obligation (*i.e.*, was in compliance with the specific Disclosure, Care, and Conflict of Interest Obligations) at the time of the recommendation. The proposed rule is not intended to change the varied advice relationships that currently exist between a broker-dealer and its retail customers, ranging from one-time, episodic or more frequent advice,<sup>143</sup> consistent with the goal of

discretionary broker-dealer recommendations, irrespective of account type.”) *But see* Letter from Ronald P. Bernardi, President and Chief Executive officer, Bernardi Securities, Inc. (Sept. 11, 2017) (“Bernardi Letter”) (suggesting consideration of a “Best Interest Standard” that “would apply to all non-discretionary (self-directed) and discretionary transaction-based, broker-dealer relationships.”). See also *infra* Section II.F.

<sup>143</sup> To that end, the intent of the proposed rule is to impose a best interest obligation on a broker-dealer when engaging in a very specific activity—the making of a recommendation to a retail customer (as defined below)—and to define the contours of that obligation. The rule is not intended to supersede the body of case law holding that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, owe customers a fiduciary duty, or the scope of obligations that attach by virtue of that duty. See, e.g., *U.S. v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006) (fiduciary duty found “most commonly” where “a broker has discretionary authority over the customer’s account”); *United States v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002) (“Although it is true that there ‘is no general fiduciary duty inherent in an ordinary broker/customer relationship,’ a relationship of trust and confidence does exist between a broker and a customer with respect to those matters that have been entrusted to the broker.”) (citations omitted); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953–954 (E.D. Mich. 1978), *aff’d*, 647 F.2d 165 (6th Cir. 1981) (recognizing that a broker who has de facto control over non-discretionary account generally owes customer duties of a fiduciary nature; looking to customer’s sophistication, and the degree of trust and confidence in the relationship, among other things, to determine duties owed); *Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948) (Commission Opinion), *aff’d sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949) (“Release 4048”) (noting that fiduciary requirements generally are not imposed upon broker-dealers who render investment advice as an incident to their brokerage unless they have placed themselves in a position of trust and confidence, and finding that Hughes was in a relationship of trust and confidence with her clients). Such broker-dealers would continue to have such fiduciary duties, subject to liability under the antifraud provisions of the federal securities laws, in addition to the express requirements of the proposed rule.

enhancing investor protection while preserving retail customer access to and choice in advice relationships.

Accordingly, the best interest obligation would not, for example: (1) Extend beyond a particular recommendation or generally require a broker-dealer to have a continuous duty to a retail customer or impose a duty to monitor the performance of the account;<sup>144</sup> (2) require the broker-dealer to refuse to accept a customer’s order that is contrary to a broker-dealer’s recommendations; or (3) apply to self-directed or otherwise unsolicited transactions by a retail customer, who may also receive other recommendations from the broker-dealer.<sup>145</sup>

We recognize, however, that a broker-dealer may agree with a retail customer by contract to take on additional obligations beyond those imposed by Regulation Best Interest, for example, by agreeing with a retail customer to hold itself to fiduciary duties, or to provide periodic or ongoing services (such as ongoing monitoring of the retail customer’s investments for purposes of recommending changes in investments).<sup>146</sup> To the extent that the broker-dealer takes on such obligations, Regulation Best Interest would apply to, and a broker-dealer would be liable for not complying with the proposed rule with respect to, any *recommendations* about securities or investment strategies made to retail customers resulting from such services. However, the best interest obligation does not impose new obligations with respect to the additional services, provided that they do not involve a recommendation to retail customers. Importantly, as noted above, Regulation Best Interest would not alter a broker-dealer’s existing obligations under the Exchange Act or any other applicable provisions of the

See also *infra* Section II.F. for a discussion and request for comment regarding broker-dealer exercise of discretion and the extent to which such exercise is “solely incidental” to the conduct of its business as a broker-dealer.

<sup>144</sup> Regulation Best Interest would not alter or diminish broker-dealers’ current supervisory obligations under the Exchange Act and detailed SRO rules, including the establishment of policies and procedures reasonably designed to prevent and detect violations of, and to achieve compliance with, the federal securities laws and regulations, as well as applicable SRO rules. See Exchange Act Section 15(b)(4)(E); FINRA Rule 3110.

<sup>145</sup> Under existing broker-dealer regulatory obligations, broker-dealers have an obligation to accurately record all recommended transactions as “solicited.” See Exchange Act Rule 17a–3(a)(6)–(7); Exchange Act Rule 17a–25(a)(2). We are not proposing any changes to these compliance requirements.

<sup>146</sup> See *infra* Section II.D.1.

federal securities laws and rules and regulations.<sup>147</sup>

In addition, under Section 29(a) of the Exchange Act, a broker-dealer would not be able to waive compliance with the rule's obligation to act in the best interest of the retail customer at the time a recommendation is made and the specific obligations thereunder, nor can a retail customer agree to waive her protection under Regulation Best Interest. Thus, the scope of Regulation Best Interest cannot be reduced by contract.

Furthermore, in addition to furthering our goal of enhancing investor protection while preserving retail customer access to and choice of advice relationships, we believe that applying the best interest obligation to when a broker-dealer is making a recommendation generally would be consistent with the DOL's approach under the DOL Fiduciary Rule and the BIC Exemption. The DOL states that the BIC Exemption "does not mandate an ongoing or long-term advisory relationship, but rather leaves the duration of the relationship to the parties."<sup>148</sup> Consistent with the DOL's interpretation of a fiduciary's monitoring responsibility in the preamble to the DOL Fiduciary Rule,<sup>149</sup> the BIC Exemption requires broker-dealers, among others, to disclose whether or not they will monitor an investor's investments and alert the investor to any recommended changes to those investments and, if so, the frequency with which the monitoring will occur and the reasons for which the investor will be alerted.<sup>150</sup> The DOL does not require broker-dealers to provide advice on an ongoing, rather than transactional, basis.<sup>151</sup> Specifically, "[t]he terms of the contract or disclosure along with other representations, agreements, or understandings between the Adviser, Financial Institution and Retirement Investor, will govern whether the nature of the relationship between the parties is ongoing or not."<sup>152</sup>

<sup>147</sup> See *supra* Section I.B (discussing a broker-dealer's existing obligations, including fiduciary obligations).

<sup>148</sup> BIC Exemption Release, 81 FR at 21032. See also DOL Fiduciary Rule Release, 81 FR at 20987 ("[T]he final rule does not impose on the person an automatic fiduciary obligation to continue to monitor the investment or the advice recipient's activities to ensure the recommendations remain prudent and appropriate for the plan or IRA. Instead, the obligation to monitor the investment on an ongoing basis would be a function of the reasonable expectations, understandings, arrangements, or agreements of the parties").

<sup>149</sup> *Id.*

<sup>150</sup> *Id.* at 21032.

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

### 3. Any Securities Transaction or Investment Strategy

The Commission proposes to apply Regulation Best Interest to recommendations of any securities transaction (sale, purchase, and exchange)<sup>153</sup> and investment strategy (including explicit recommendations to hold a security or regarding the manner in which it is to be purchased or sold) to retail customers.<sup>154</sup> Securities transactions may also include recommendations to roll over or transfer assets from one type of account to another, such as recommendations to roll over or transfer assets in an ERISA account to an IRA.<sup>155</sup>

We are not proposing at this time that the duty extend to recommendations of account types generally, unless the recommendation is tied to a securities

<sup>153</sup> This approach is consistent with existing broker-dealer suitability obligations. Regulation Best Interest applies only to recommendations, and not to the execution of a recommended transaction, which as discussed below is addressed by existing broker-dealer best execution obligations. See, e.g., FINRA Rule 5310 (Best Execution and Interpositioning). Regulation Best Interest is separate from and does not alter these obligations. See generally *infra* Section II.D.2, for discussion of a broker-dealer's best execution obligations.

<sup>154</sup> FINRA interprets what is an investment strategy broadly. Examples of investment strategies are recommendations to purchase the "Dogs of the Dow," securities on margin, liquify home mortgages, or explicit recommendations to hold securities. See FINRA Regulatory Notice 12-25 at Q7. Similarly, under antifraud case law, a recommendation can also encompass the manner for purchasing or selling the security. A recommendation to purchase on margin, if unsuitable, may violate antifraud provisions of the Exchange Act in the absence of disclosure. See *Troyer v. Karcagi*, 476 F. Supp. 1142, 1152 (S.D.N.Y. 1979) (opening an unsuitable margin account, without disclosure of the unsuitability to the customer, renders a broker-dealer primarily liable under section 10(b) and Rule 10b-5 if it acts with scienter); *Steven E. Muth and Richard J. Rouse*, Exchange Act Release No. 52551, at \*19, 58 SEC. 770, 797 (Oct. 3, 2005) (Commission opinion) (finding registered representative's recommendations of risky margin purchases to customers who had relatively modest financial profiles and conservative investment objectives, where he also misled customers regarding adverse impact of margin trading, were unsuitable). See also *William J. Murphy and Carl M. Birkelbach*, Exchange Act Release No. 69923, at \*17 (July 2, 2013) (Commission opinion, sustaining FINRA findings) ("The large margin debit balance in Lowry's account exacerbated the unsuitability of Murphy's already risky trading.").

<sup>155</sup> A recommendation concerning the type of retirement account in which a customer should hold his retirement investments typically involves a recommended securities transaction, and thus is subject to FINRA suitability obligations. For example, a firm may recommend that an investor sell his plan assets and roll over the cash proceeds into an IRA. Recommendations to sell securities in the plan or to purchase securities for a newly-opened IRA are subject to FINRA suitability obligations. See FINRA Regulatory Notice 13-45. As previously noted, recommendations of unsuitable transactions may also violate the antifraud provisions of Securities Act Section 17(a); Exchange Act Section 10(b) and Rule 10b-5 thereunder.

transaction (e.g., to roll over or transfer assets such as IRA rollovers). Evaluating the appropriateness of an account is an issue that implicates both broker-dealers and investment advisers that are making recommendations of a brokerage account or an advisory account. Accordingly, we are requesting comment below about the obligations that apply to both broker-dealers and investment advisers relating to recommendations of accounts generally, and whether and how we should address those obligations.

### 4. Retail Customer

The Commission proposes to define "retail customer" as: "a person, or the legal representative of such person, who: (1) 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 (2) uses the recommendation primarily for personal, family, or household purposes."<sup>156</sup> The definition generally tracks the definition of "retail customer" under Section 913(a) of the Dodd-Frank Act, except as discussed below.

The Commission preliminarily believes this proposed definition is appropriate, and in particular, the limitation to recommendations that are "primarily for personal, family or household purposes," as we believe it excludes recommendations that are related to business or commercial purposes, but remains sufficiently broad and flexible to capture recommendations related to the various reasons retail customers may invest (including, for example, for retirement, education, and other savings purposes). As discussed in more detail above, the Commission and studies have historically been, and continue to be, focused on the potential investor harm that conflicted advice can have on investors investing for present and future financial goals.<sup>157</sup> The

<sup>156</sup> We believe that, pursuant to existing regulations, broker-dealers would generally be required to obtain sufficient facts concerning a retail customer to determine an account's primary purpose for purposes of Regulation Best Interest. For example, FINRA members are required to use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer. See FINRA Rule 2090 (Know Your Customer). Additionally, FINRA members are required to ascertain the customer's investment profile under FINRA suitability obligations. See FINRA Rule 2111 (Suitability).

<sup>157</sup> See, e.g., 913 Study (focusing on retail investors trying to manage their investments to meet their own and their families' financial goals);

Commission continues to believe the focus of Regulation Best Interest should remain on investors with these personal goals but we request comment below on whether the definition of “retail customer” should be expanded or harmonized with the proposed definition of “retail investor” in the Relationship Summary Proposal, as defined and described below.

As noted, this definition differs from the definition of “retail customer” under Section 913 in three relevant aspects. First, for the reasons discussed above,<sup>158</sup> the Commission proposes to substitute “recommendation of any securities transaction or investment strategy involving securities” for “personalized investment advice about securities.”

Second, the Commission proposes to extend the Section 913 definition beyond natural persons to *any persons*, provided the recommendation is primarily for personal, family, or household purposes. This extension would cover non-natural persons that the Commission believes would benefit from the protections of Regulation Best Interest (such as trusts that represent the assets of a natural person).<sup>159</sup> As discussed in Section II.E below, in light of this expansion from “natural person” to any person, we are proposing a new, separate recordkeeping requirement, as, among other things, the similar existing recordkeeping requirements refer only to “natural persons.”

Third, the proposed definition would only apply to a person who “receives a recommendation . . . from a broker or dealer or a natural person who is an

associated person of a broker or dealer,” and does not include a person who receives a recommendation from an investment adviser acting as such. This definition is appropriate as Regulation Best Interest only applies in the context of a brokerage relationship with a brokerage customer, and in particular, when a broker-dealer is making such a recommendation in the capacity of a broker-dealer.<sup>160</sup> In other words, Regulation Best Interest would not apply to the relationship between an investment adviser and its advisory client (or any recommendations made by an investment adviser to an advisory client).<sup>161</sup> Accordingly, dual-registrants would be required to comply with Regulation Best Interest only when making a recommendation in their capacity as a broker-dealer.

Regulation Best Interest and its specific obligations, including the Disclosure Obligation, Care Obligation, and Conflicts Obligations, would not apply to advice provided by a dual-registrant when acting in the capacity of an investment adviser, even if the person to whom the recommendation is

made also has a brokerage relationship with the dual-registrant or even if the dual-registrant executes the transaction. Similarly, when an investment adviser provides advice, the rule would not apply to an affiliated broker-dealer or to a third-party broker-dealer with which a natural associated person of the investment advisers is associated if such broker-dealer executes the transaction in the capacity of a broker or dealer. For example, in the case of a dual-registrant that provides advice with respect to an advisory account and subsequently executes the transaction, Regulation Best Interest would not apply to the advice and transaction because the firm acted in the capacity of a broker-dealer solely when executing the transaction and not when providing advice about a securities transaction. In this case, when the advice is provided in the capacity of an investment adviser, the firm would be required to comply with the obligations prescribed under an investment adviser’s fiduciary duty, as described in more detail in the Fiduciary Duty Interpretive Release.

The Commission recognizes that making the determination of whether a dual-registrant is acting in the capacity of a broker-dealer or an investment adviser is not free from doubt, and this issue has existed for dual-registrants prior to the proposal of Regulation Best Interest. Generally, determining whether a recommendation made by a dual-registrant is in its capacity as broker-dealer requires a facts and circumstances analysis, with no one factor being determinative. When evaluating this issue, the Commission considers, among other factors, the type of account (advisory or brokerage), how the account is described, the type of compensation, and the extent to which the dual-registrant made clear the capacity in which it was acting to the customer or client. We also have held the view that a dual-registrant is an investment adviser solely with respect to those accounts for which it provides advice or receives compensation that subjects it to the Advisers Act.<sup>162</sup> This interpretation of the Advisers Act permits a dual-registrant to distinguish its brokerage customers from its advisory clients. We recognize that this determination can leave interpretive and other challenges for dual-registrants with clients that have both brokerage and advisory accounts with the dual-registrant. Our Disclosure Obligation is designed to help address some of these challenges as the Commission believes

RAND Study; Siegel & Gale Study; CFA 2010 Survey. See also IAC Recommendation; Section I.A.

<sup>158</sup> See *supra* Section II.C.2.

<sup>159</sup> This differs from the approach taken under current FINRA suitability obligations, which as discussed below, provide an exemption to broker-dealers from the customer-specific suitability obligation with respect to “institutional accounts,” including very high net worth natural persons, if certain conditions are met. Under the Commission’s proposal, to the extent that the recommendation is not primarily used for personal, family, or household purposes, “institutional accounts,” as defined in FINRA Rules, would fall outside the definition of retail customer and be excluded from Regulation Best Interest, and as a consequence recommendations to such accounts would be solely subject to FINRA’s suitability rule.

Under the FINRA rules, a broker-dealer’s suitability obligations are different for certain institutional customers than for non-institutional customers. A broker-dealer is exempt from its customer-specific suitability obligation for an institutional account, if the broker-dealer: (1) Has a reasonable basis to believe that the institutional customer is capable of evaluating the risks independently, both in general and with regard to particular transactions and investment strategies, and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the broker-dealer’s recommendations. FINRA 2111(b).

<sup>160</sup> This approach will facilitate broker-dealers building upon their current compliance infrastructure and will enhance investor protections to retail customers seeking financial services. FINRA’s suitability rule applies to a person who is not a broker-dealer who opens a brokerage account at a broker-dealer or who purchases a security for which the broker-dealer receives or will receive, directly or indirectly, compensation even though the security is held at an issuer, the issuer’s affiliate or custodial agent, or using another similar arrangement. See FINRA Regulatory Notice 12–55, Guidance on FINRA’s Suitability Rule (Dec. 2012) at Q6(a). A broker-dealer customer relationship could also arise if the individual or entity has an informal business relationship related to brokerage services, as long as the individual or entity is not a broker-dealer. See FINRA Regulatory Notice 12–25 at Q6.

In some instances, a brokerage relationship with a brokerage customer can exist without a formal brokerage account (e.g., as established by an agreement with the broker-dealer). For example, broker-dealers can assist retail customers in purchasing mutual funds or variable insurance products to be held with the mutual fund or variable insurance product issuer, by sending checks and applications directly to the fund or issuer (this is sometimes referred to as “check and application,” “application-way,” “subscription-way” or “direct application” business; we use the term “check and application” for simplicity) even if that retail investor does not have an account with the broker-dealer. The broker-dealer is typically listed as the broker-dealer of record on the retail customer’s account application, and generally receives fees or commissions resulting from the retail customer’s transactions in the account. See, e.g., FINRA Notice to Members 04–72, Transfers of Mutual Funds and Variable Annuities (Oct. 2004). Regulation Best Interest would apply to recommendations of such transactions even in the absence of a formal account.

<sup>161</sup> In a concurrent release, we are proposing an interpretation that would reaffirm—and in some cases clarify—certain aspects of the fiduciary duty that an investment adviser owes to its clients. See Fiduciary Duty Interpretive Release.

<sup>162</sup> See Release 51523; 2007 Proposing Release.

it will help clarify the capacity in which a dual-registrant is acting.

By proposing Regulation Best Interest, we are not intending to change the analysis regarding whether an investor is a brokerage customer or an advisory client, as we believe this issue is outside the scope of this rulemaking.<sup>163</sup>

However, we seek comment below on this historical approach and whether particular scenarios involving investors with brokerage and advisory accounts need further clarification.

The proposed definition of “retail customer” also differs from the definition of “retail investor” proposed in the Relationship Summary Proposal, which is a prospective or existing client or customer who is a natural person (an individual), regardless of the individual’s net worth (thus including, e.g., accredited investors, qualified clients or qualified purchasers).<sup>164</sup> The relationship summary contemplated in the Relationship Summary Proposal, as defined and described below in Section II.D.1., is intended for a broader range of investors, before or at the time they first engage the services of a broker-dealer, to provide important information for them to consider when choosing a firm and a financial professional.<sup>165</sup> The Commission does not believe it is inconsistent or inappropriate, but rather beneficial, to require firms to provide a relationship summary to all natural persons to facilitate their understanding of the account choices, regardless of whether the retail customers will receive recommendations primarily for personal, family, or household purposes. Regulation Best Interest and its intended focus, however, is more limited in scope, in order to cover recommendations to “retail customers” who have chosen to engage the services of a broker-dealer after receiving the Relationship Summary required by the Relationship Summary Proposal.<sup>166</sup>

Furthermore, consistent with the definition of “retail customer” in Section 913 of the Dodd-Frank Act, except as noted above, and the 913 Study recommendation, the Commission is proposing to limit the application of Regulation Best Interest to any person, or the legal representative of such person, receiving and using a recommendation primarily for personal,

family, or household purposes, such as trusts that represent natural persons.

Given that our proposed definition applies to “any person” and not “natural persons” as used in the Relationship Summary Proposal, we believe it is appropriate to limit the definition to persons who receive recommendations primarily for these specified purposes, consistent with the Commission’s historical focus,<sup>167</sup> as we do not intend at this time for Regulation Best Interest to apply to all recommendations to any person. Without such a limitation, we are concerned that this rule would apply to recommendations that are primarily for business purposes (such as any recommendations to institutions), which is beyond the intended focus of Regulation Best Interest, as discussed above.

#### 5. Request for Comment on Key Terms and Scope of Best Interest Obligation

The Commission requests comment generally on the key terms and scope of the best interest obligation.

- Do commenters agree with the general approach of the best interest obligation of building on existing requirements?
- Should retail customers be permitted to amend their contracts with broker-dealers to modify the terms of Regulation Best Interest?

The Commission also requests comment specifically on the proposed definition of “natural person who is an associated person.”

- Do commenters agree that proposed Regulation Best Interest should apply to natural persons that are associated persons of a broker-dealer? Why or why not?

- Are there alternative definitions that the Commission should consider?

- Is the proposed rule’s limitation of applicability to “a natural person who is an associated person” appropriate? Why or why not?

- Should the Commission broaden or limit the scope of individuals to whom Regulation Best Interest applies? For example, should it apply to small business entities such as a sole proprietorship? Why or why not?

The Commission also requests comment specifically on the scope of the term “recommendation.”

- Should the Commission define the term “recommendation”? If so, should we define “recommendation” as described above?

- Does the term “recommendation” capture all of the actions to which

Regulation Best Interest should apply? Why or why not?

- Should the Commission limit the application of Regulation Best Interest to when a recommendation is made? Why or why not?

- Is sufficient clarity provided regarding what “at the time the recommendation is made” means? Should the Commission define this phrase? Why or why not?

- Should Regulation Best Interest also cover broker-dealers that only offer a limited range of products, or that are engaging in other activities, even when not making a “recommendation” as discussed above? Why or why not?

- Instead, should Regulation Best Interest apply when a broker-dealer is providing “personalized investment advice”? Why or why not? If so, how should the Commission define “personalized investment advice”? Should the Commission definition follow the 913 Study, which recommended that such a definition should *at a minimum* encompass the making of a “recommendation,” and should not include “impersonal investment advice”?<sup>168</sup> What broker-dealer activities would be covered by using this definition that would not be currently covered by limiting the rule to a “recommendation”?

- As noted above, the term “recommendation” has been interpreted in the context of Commission rules, the FINRA suitability requirement, and the DOL Fiduciary Rule. Should the Commission define or describe more fully what is a “recommendation” in this context? Should the Commission interpret the term “recommendation” differently than it has been interpreted by the Commission and FINRA to date? If so, what should the interpretation be and why? In what specific circumstances, if any, would additional guidance as to the meaning of “recommendation” be useful? Does the description of what would be a recommendation provide sufficient clarity in this regard? Why or why not?

- Has the Commission appropriately distinguished a recommendation from investor education? Why or why not? If not, what communications should be considered a recommendation or alternatively, investor education? How would these situations differ from the current standards with respect to what is a recommendation versus investor education?

- Regulation Best Interest would apply to both discretionary and non-discretionary recommendations made by a broker-dealer. Do commenters agree

<sup>163</sup> *Id.*

<sup>164</sup> The definition of “retail investor” would include a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust. See Relationship Summary Proposal, *supra* Section II.D.1.

<sup>165</sup> See Relationship Summary Proposal, *supra* note 8 and accompanying text.

<sup>166</sup> *Id.*

<sup>167</sup> See *supra* notes 157 and 166 and accompanying text.

<sup>168</sup> See 913 Study at 123–27.



that Regulation Best Interest should apply to any discretionary recommendation made by a broker-dealer?<sup>169</sup> Courts have found broker-dealers that exercise discretion or de facto control of an account to be fiduciaries under state law. What additional protections do brokerage customers receive, if any, when their broker-dealers are considered fiduciaries under state law? Does Regulation Best Interest adequately account for these additional protections?

The Commission requests comment on the scope of “any securities transaction or investment strategy involving securities.”

- Do commenters agree that proposed Regulation Best Interest should apply to recommendations of “any securities transaction or investment strategy involving securities”? Do commenters agree with our proposed interpretation of the scope of these terms? Why or why not?

- Do commenters have alternative suggestions on the types of recommendations to which Regulation Best Interest would apply? Please specifically identify any recommendations that should be covered by the proposed rule and explain why they should be covered.

- Are there other broker-dealer recommendations that are not captured by these terms that should be covered by Regulation Best Interest? Please specify any recommendations that would not be covered by the proposed rule and why they should or should not be covered.

- Should the Commission provide additional guidance as to what is or is not an “investment strategy involving securities”? Please identify where further guidance is needed and why recommendations should or should not be viewed as an “investment strategy involving securities.”

- Should the Commission extend Regulation Best Interest to recommendations of account types even if the recommendation is not tied to a securities transaction? If so, what factors should a broker-dealer consider in making a recommendation of an account type? Should the factors differ if the account type recommended is discretionary versus non-discretionary? Should they differ for dual-registrants versus standalone broker-dealers?

- Should the rule include an obligation to perform ongoing or

periodic evaluation of whether an account type initially recommended remains appropriate? If so, how frequently and what factors should that evaluation take into consideration?

- What factors do firms consider in determining the appropriateness of an account for a particular investor, if any, and what weight is given to the factors considered (*i.e.*, do certain factors carry more weight than others)?

- What policies and procedures do firms currently use, if any, to supervise recommendations by their associated persons of account types?

- How do firms mitigate incentives for associated persons to recommend inappropriate account types?

The Commission requests comment on the definition of “retail customer.”

- Do commenters agree with the proposed definition of “retail customer”? Why or why not? Should the definition be narrowed or expanded in any way? For example, should it apply to small business entities such as a sole proprietorship? Why or why not?

- Are there are other definitions of “retail customer” that the Commission should consider? If so, please provide any alternative definition and the reasons why it is being suggested. For example, should the Commission instead use the definition of “retail investor” that is being proposed in the Relationship Summary or that is used in the 913 Study?

- Regulation Best Interest would apply to recommendations to retail customers, while FINRA’s general suitability requirements apply to recommendations to all customers (although a broker-dealer is exempt from its customer-specific suitability obligation for an institutional account, if certain conditions are met).<sup>170</sup> Do commenters agree that having differing standards of care for different broker-dealer customers is appropriate? Why or why not? Would differing standards for different customers of broker-dealers confuse retail or other customers? Would differing standards for different customers make it more difficult for broker-dealers to comply with their obligations?

- Do commenters believe that the definition of “retail customer” should instead only include all natural persons as under Section 913? Why or why not?

- Do commenters believe the limitation of the proposed definition of “retail customer” to recommendations primarily for “personal, family or household purposes” is appropriate and clear? Why or why not? As proposed, the definition of “retail customer,”

including the limitation, would cover, for example, participants in ERISA-covered plans and IRAs. Should participants in these types of plans be covered? Why or why not? Do firms require more guidance regarding the current application of the law to specific scenarios? Should the limitation be omitted? Why or why not?

- The Commission requests comment on the proposed approach with respect to dual-registrants. How do firms currently make the determination of what capacity a dual-registrant is acting in when making a recommendation or otherwise? Do commenters require more guidance regarding the current application of the law to specific scenarios? Do commenters agree with the Commission’s interpretations of when a dual-registrant is acting as an investment adviser? Why or why not? Do commenters agree with the Commission’s interpretations of when a dual-registrant is acting as a broker-dealer? Why or why not?

#### *D. Components of Regulation Best Interest*

As part of Regulation Best Interest, we are proposing specifying that the obligation to “act in the best interest of the retail customer . . . without placing the financial or other interest of the [broker-dealer] ahead of the retail customer” shall be satisfied if the broker-dealer complies with four component requirements: A Disclosure Obligation, a Care Obligation, and two Conflict of Interest Obligations. Each of these components is discussed below. Failure to comply with any of these requirements when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer would violate Regulation Best Interest.

In specifying by rule these obligations, we intend to provide clarity to broker-dealers on the requirements of the best interest obligation. To that end, the best interest obligation does not impose any obligations other than those specified by the rule: Namely, to act in the best interest of the retail customer without placing the financial or other interest of the broker-dealer ahead of the retail customer’s interest, by complying with each of the components as set forth in paragraph (a)(2) of the rule.

We wish to reemphasize that we recognize that components of these obligations draw from obligations that have been interpreted under the antifraud provisions of the federal securities laws, or may be specifically addressed by the Exchange Act or the rules thereunder or SRO rules. In proposing these obligations, we are not

<sup>169</sup> See also *infra* Section II.F. for a discussion and request for comment regarding broker-dealer exercise of discretion and the extent to which such exercise is “solely incidental” to the conduct of its business as a broker-dealer.

<sup>170</sup> FINRA Rule 2111(b).

proposing to amend or eliminate existing broker-dealer obligations, and compliance with Regulation Best Interest is not determinative of a broker-dealer's compliance with obligations under the general antifraud provisions of the federal securities laws.<sup>171</sup>

### 1. Disclosure Obligation

The Commission is proposing the Disclosure Obligation, which would require a broker-dealer, or natural person who is an associated person of a broker or dealer "to, prior to or at the time of such recommendation, reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest associated with the recommendation." We believe that an important aspect of the broker-dealer's best interest obligation is to facilitate its retail customers' awareness of certain key information regarding their relationship with the broker-dealer.<sup>172</sup> Specifically, and as discussed more below, to meet the Disclosure Obligation, we would consider the following to be examples of material facts relating to the scope and terms of the relationship with the retail customer: (i) That the broker-dealer is acting in a broker-dealer capacity with respect to the recommendation; (ii) fees and charges that apply to the retail

<sup>171</sup> Any transaction or series of transactions, whether or not effected pursuant to the provisions of Regulation Best Interest, remain subject to the antifraud and anti-manipulation provisions of the securities laws, including, without limitation, Section 17(a) of the Securities Act [15 U.S.C. 77q(a)] and Sections 9, 10(b), and 15(c) of the Exchange Act [15 U.S.C. 78i, 78j(b), and 78o(c)].

<sup>172</sup> Several commenters maintained that a disclosure requirement with such information would be an effective approach to addressing consumer confusion. See, e.g., State Farm 2017 Letter (recommending a simplified account opening disclosure that includes: (1) The type of relationship being entered into and specific duties owed to the consumer based on the services performed; (2) the services available as part of the relationship, and information about applicable direct and indirect investment-related fees; and (3) information about material conflicts of interest that apply to these relationships, including material conflicts arising from compensation arrangements or proprietary products); Letter from Paul S. Stevens, President and CEO, Investment Company Institute (Feb. 5, 2018) ("ICI February 2018 Letter") (recommending a best interest standard requiring broker-dealers to disclose to retail customers certain aspects of their relationship with the retail customer, "such as the type and scope of services provided, the applicable standard of conduct, the types of compensation it or its associated persons receive, and any material conflicts of interest"); Letter from Michelle B. Oroschakoff, LPL Financial, (Feb. 22, 2018) ("LPL Financial") (recommending a standard of conduct that requires clear and comprehensive disclosure to retail investors explaining material information about their services, including the nature of the services, investment products, compensation, and material conflicts of interest).

customer's transactions, holdings, and accounts; and (iii) type and scope of services provided by the broker-dealer, including, for example, monitoring the performance of the retail customer's account. While these examples are indicative of what the Commission believes would generally be material facts regarding the scope and terms of the relationship, brokers, dealers, and natural persons who are associated persons of a broker or dealer would need to determine what other material facts relate to the scope and terms of the relationship, and reasonably disclose them in writing prior to or at the time of a recommendation. Additionally, this Disclosure Obligation would explicitly require the broker-dealer to, prior to or at the time of such recommendation, reasonably disclose in writing all material conflicts of interest<sup>173</sup> associated with the recommendation.

We understand that broker-dealers typically provide information about their services and accounts, which may include disclosure concerning the broker-dealer's capacity, fees, services, and conflicts,<sup>174</sup> on their firm websites and in their account opening agreements. While broker-dealers are subject to a number of specific disclosure obligations when they effect certain customer transactions,<sup>175</sup> and

<sup>173</sup> Under Regulation Best Interest, as proposed, a broker-dealer's obligation to disclose material conflicts of interest would resemble the duty to disclose material conflicts that has been imposed on broker-dealers found to be acting in a fiduciary capacity. See, e.g., *United States v. Szur*, 289 F.3d 200, 212 (2d Cir. 2002) (broker's fiduciary relationship with customer gave rise to a duty to disclose commissions to customer, which would have been relevant to customer's decision to purchase stock); *Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948) (Commission Opinion), *aff'd sub nom. Hughes v. Sec. & Exch. Comm'n*, 174 F.2d 969, 976 (D.C. Cir. 1949) (broker acted in the capacity of a fiduciary and, as such, broker was under a duty to make full disclosure of the nature and extent of her adverse interest, "including her cost of the securities and the best price at which the security might be purchased in the open market").

<sup>174</sup> The 913 Study noted that, in practice, required disclosures of conflicts have been more limited with broker-dealers than with investment advisers. See 913 Study at 106. In addition, the Tully Report focused on the potential harm to investors due to broker-dealer conflicts of interest and in particular those related to compensation. As a best practice, the Tully Report suggested increased disclosure. See also Tully Report at 16 (finding that full disclosure of the broker-dealer compensation practices could reduce the "potential for conflict and abuse"); discussion *supra* Section I.A.

<sup>175</sup> See, e.g., Exchange Act Rule 10b-10, which generally requires a broker-dealer effecting customer transactions in securities (other than U.S. savings bonds or municipal securities) to provide written notification to the customer, at or before completion of the transaction, disclosing information specific to the transaction, including whether the broker-dealer is acting as agent or principal and its compensation, as well as any third-party remuneration it has received or will

are subject to additional disclosure obligations under the antifraud provisions of the federal securities laws,<sup>176</sup> broker-dealers are not currently subject to an explicit and broad disclosure requirement under the Exchange Act.<sup>177</sup> To promote broker-

receive. 17 CFR 240.10b-10. See also Exchange Act Rules 15c1-5 and 15c1-6, which require a broker-dealer to disclose in writing to the customer if it has any control, affiliation, or interest in a security it is offering or the issuer of such security. 17 CFR 240.15c1-5 and 15c1-6. There are also specific, additional obligations that apply, for example, to recommendations by research analysts in research reports and to public appearances under Regulation Analyst Certification (AC). See, e.g., 17 CFR 242.500 *et seq.* Finally, SRO rules apply to specific situations, such as FINRA Rule 2124 (Net Transactions with Customers); FINRA Rule 2262 (Disclosure of Control Relationship with Issuer), and FINRA Rule 2269 (Disclosure of Participation or Interest in Primary or Secondary Distribution).

<sup>176</sup> See, e.g., *supra* note 87. Broker-dealers are liable under the antifraud provisions for failure to disclose material information to their customers when they have a duty to make such disclosure. See *Basic v. Levinson*, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent a duty to disclose, is not misleading under Rule 10b-5."); *Chiarella v. U.S.*, 445 U.S. 222, 228 (1980) (explaining that a failure to disclose material information is only fraudulent if there is a duty to make such disclosure arising out of "a fiduciary or other similar relation of trust and confidence"); *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999) (explaining that defendant is liable under Section 10(b) and Rule 10b-5 for material omissions "as to which he had a duty to speak").

Generally, under the antifraud provisions, a broker-dealer's duty to disclose material information to its customer is based upon the scope of the relationship with the customer, which is fact intensive. See, e.g., *Conway v. Iahn & Co., Inc.*, 16 F.3d 504, 510 (2d Cir. 1994) ("A broker, as agent, has a duty to use reasonable efforts to give its principal information relevant to the affairs that have been entrusted to it.").

For example, where a broker-dealer processes its customers' orders, but does not recommend securities or solicit customers, then the material information that the broker-dealer is required to disclose is generally narrow, encompassing only the information related to the consummation of the transaction. See, e.g., *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 536 (2d Cir. 1999). However, courts and the Commission have found that a broker-dealer's duty to disclose material information under the antifraud provisions is broader when the broker-dealer is making a recommendation to its customer. See, e.g., *Hanly*, 415 F.2d 589, 597 (2d Cir. 1969). When recommending a security, broker-dealers generally are liable under the antifraud provisions if they do not give "honest and complete information" or disclose any material adverse facts or material conflicts of interest, including any economic self-interest. See, e.g., *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970).

<sup>177</sup> Broker-dealers may be subject to additional disclosure requirements imposed by other regulators. For example, as noted, the BIC Exemption and related PTEs impose detailed disclosure conditions on broker-dealers that rely on those exemptions. Other DOL regulations and exemptions also impose disclosure requirements applicable to broker-dealers providing advisory and other services to ERISA-covered plans and IRAs. See, e.g., 29 CFR 2550.408g-1(b)(7)(G) (regulation

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dealer recommendations that are in the best interest of retail customers, we believe it is necessary to impose a more explicit disclosure obligation on broker-dealers than what currently exists under the federal securities laws and SRO rules.

This Disclosure Obligation also forms an important part of a broader effort to address retail investor confusion, as further discussed in a separate concurrent rulemaking.<sup>178</sup> Studies have shown that retail investors are confused about the differences among financial service providers, such as broker-dealers, investment advisers, and dual-registrants.<sup>179</sup> We have carefully considered these concerns regarding investor confusion, and are committed to facilitating greater clarity for retail investors. In our concurrent rulemaking, we propose to:<sup>180</sup> (1) Require broker-dealers and investment advisers to provide to retail investors<sup>181</sup> a short (*i.e.*, four page or equivalent limit if in electronic format) relationship summary (“Relationship Summary”);<sup>182</sup> (2) restrict broker-dealers and associated natural persons of broker-dealers, when communicating with a retail investor, from using the term “adviser” or “advisor” in specified circumstances; and (3) require broker-dealers and investment advisers, and their associated natural persons and supervised persons, respectively, to disclose, in retail investor communications, the firm’s registration status with the Commission and an associated natural person’s and/or supervised person’s relationship with the firm (“Regulatory Status Disclosure”).<sup>183</sup>

These proposed obligations reflect common goals and touch on issues that are also contemplated under the

under statutory exemption for participant advice requires fiduciary advisers to plans and IRAs seeking relief to deliver certain disclosures and acknowledge fiduciary status); 29 CFR 2550.408b-2(c)(iv)(B) (regulation under statutory exemption for reasonable service arrangements requires certain ERISA plan service providers to disclose certain information in writing including (among other things) a description of the services to be provided, the fees to be paid directly and indirectly by the plan and, if applicable, a statement that the service provider will provide or reasonably expects to provide services as a “fiduciary” as defined by ERISA).

<sup>178</sup> See Relationship Summary Proposal.

<sup>179</sup> See, *e.g.*, Siegel & Gale Study; RAND Study. See also CFA 2010 Survey.

<sup>180</sup> See Relationship Summary Proposal.

<sup>181</sup> As described in more detail under the definition of “retail customer” in Section II.C.4, the definition used in this proposed rulemaking differs from the definition of “retail investor” used in the Relationship Summary Proposal.

<sup>182</sup> The customer or client relationship summary is being proposed as “Form CRS.”

<sup>183</sup> See Relationship Summary Proposal.

proposed Disclosure Obligation under Regulation Best Interest, notably clarifying the capacity in which a firm or financial professional is acting, minimizing investor confusion, and facilitating greater awareness of key aspects of a relationship with a firm or financial professional, such as the applicable standard of conduct, fees, and material conflicts of interest. We believe these obligations complement each other and, consistent with our layered approach to disclosure, are designed to build upon each other to provide different levels of key information that we preliminarily believe are appropriate at different points of the relationship with a broker-dealer.

The Relationship Summary highlights certain features of an investment advisory or brokerage relationship, which is designed to alert retail investors to information for them to consider when choosing a firm and a financial professional. This would be achieved by requiring that the Relationship Summary be initially delivered to a retail investor before or at the time a retail investor enters into an investment advisory agreement or first engages a brokerage firm’s services.<sup>184</sup>

By virtue of the high level nature of the disclosures in the Relationship Summary, constituting a mix of prescribed language and more firm-specific disclosures, and the space constraints (no more than four pages or equivalent limit if in electronic format), the Relationship Summary would form just one part of a broker-dealer’s broader set of disclosures. Firms would include information retail investors need to understand the services, fees, conflicts, and disciplinary history of firms and financial professionals they are considering, along with references and links to other disclosure where interested investors can find more detailed information. In this way, the Relationship Summary is intended to foster a layered approach to disclosure, as described above. It is also designed to facilitate comparisons across firms that offer the same or substantially similar services.<sup>185</sup>

The Disclosure Obligation under Regulation Best Interest further builds

<sup>184</sup> We note that the Relationship Summary may be provided *after* the retail investor has initially decided to meet with the firm or its financial professional, a selection which may have been based on such person’s name or title. This highlights the importance of facilitating clarity and accuracy in the use of names and titles, as is intended by the proposed restrictions on titles and the Regulatory Status Disclosure. See Relationship Summary Proposal.

<sup>185</sup> For further discussion, see Relationship Summary Proposal.

on and complements these obligations as it would require a broker-dealer or natural person who is an associated person of a broker-dealer or, prior to or at the time of the recommendation, reasonably disclose, in writing, the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest associated with the recommendation. The Disclosure Obligation under Regulation Best Interest would apply specifically to the broker-dealer or natural person who is an associated person of the broker-dealer and the specific recommendation triggering Regulation Best Interest.

For example, whereas the Relationship Summary would require a brief and general description of the types of fees and expenses that retail investors will pay, under the Disclosure Obligation we would generally expect broker-dealers to build upon the Relationship Summary to provide more specific fee disclosures relevant to the recommendation to the retail customer and the particular brokerage account for which recommendations are made. In addition, while the Relationship Summary would require a high-level description of specified conflicts of interest, the Disclosure Obligation would require more comprehensive disclosure of all material conflicts of interest related to the recommendation to the retail customer.

Thus, as a general matter, the Regulatory Status Disclosure and the Relationship Summary reflect initial layers of disclosure, with the Disclosure Obligation reflecting more specific and additional, detailed layers of disclosure.<sup>186</sup>

#### a. Disclosure of Material Facts Relating to the Scope and Terms of the Relationship

As noted above, to meet this Disclosure Obligation, we would generally consider the following to be examples of material facts relating to the scope and terms of the relationship with the retail customer: (i) That the broker-dealer is acting in a broker-dealer capacity with respect to the recommendation; (ii) fees and charges that apply to the retail customer’s transactions, holdings, and accounts; and (iii) type and scope of services provided by the broker-dealer, including, for example, monitoring the performance of the retail customer’s account. This Disclosure Obligation

<sup>186</sup> Nevertheless, as discussed below where relevant, in some instances, disclosures made pursuant to the Regulatory Status Disclosure or the Relationship Summary may be sufficient to satisfy some aspects of this Disclosure Obligation.

would also require broker-dealers and natural persons who are associated persons of the broker-dealer to determine, based on the facts and circumstances, whether there are other material facts relating to the scope and terms of the relationship with the retail customer that would need to be disclosed. For example, this would include considering whether it is necessary, and if so how, to build upon the high-level summary disclosures pursuant to the Relationship Summary.

#### (1) Capacity

We have identified the capacity in which a broker-dealer is acting as a likely material fact relating to the scope and terms of the relationship that would be subject to the Disclosure Obligation. In doing so, we hope to achieve greater awareness among retail customers of the capacity in which their financial professional or firm acts when it makes recommendations<sup>187</sup> so that the retail customer can more easily identify and understand the relationship, scope of services, and standard of conduct that applies to such recommendations. As noted above, the broker-dealer's standard of conduct would be disclosed in plain language in the Relationship Summary.

For a broker-dealer that is not a dual-registrant (a "standalone broker-dealer"), or a natural person that is an associated person of a standalone broker-dealer (and that natural person is not also a supervised person of a registered investment adviser), the broker-dealer or associated person would disclose that it is acting in a broker-dealer capacity by complying with the Relationship Summary and the Regulatory Status Disclosure requirements of the Relationship Summary Proposal, described above. Because the Disclosure Obligation would require disclosure "prior to, or at the time of" the recommendation, the broker-dealer generally would not be expected to repeat the disclosure each time it makes a recommendation. Rather, we would consider the broker-dealer to have reasonably disclosed the capacity in which it is acting at the time of the recommendation, if the broker-dealer had already—"prior to . . . the time of" the recommendation—delivered the Relationship Summary to the retail customer in accordance with the requirements of proposed Exchange Act Rule 17a-14 and had complied with the Regulatory Status Disclosure. We believe that delivery of the Relationship Summary would clearly articulate to the retail customer that he/she has a

relationship with a broker-dealer, and that the broker-dealer must act in his/her best interest when providing advice in the form of a recommendation in the capacity of a broker or dealer, in addition to other specified information concerning the broker-dealer. Moreover, the Regulatory Status Disclosure would help ensure that each written or electronic investor communication clearly alerts the retail customer to the capacity in which the firm or financial professional acts.

Retail customers of dual-registrants or of financial professionals who are dually-registered may be more susceptible to confusion regarding the capacity in which their firms or financial professionals are acting with respect to any particular recommendation. For that reason, delivery of the Relationship Summary and compliance with the Regulatory Status Disclosure would not be considered reasonable disclosure of the capacity in which a dually-registered broker-dealer or dually-registered individual is acting at the time of the recommendation. Pursuant to the Relationship Summary Proposal, a dual-registrant would deliver to the retail customer a Relationship Summary that describes both the brokerage and advisory services offered by the firm, and as such, would not provide clarity regarding the capacity in which the dual-registrant is acting in the context of any particular recommendation. Similarly, the Regulatory Status Disclosure would require disclosure of both capacities in which firms and financial professionals act. Therefore, the Commission would expect a broker-dealer that is a dual-registrant to do more to meet the Disclosure Obligation.

As discussed below in our guidance on reasonable disclosure, we are not proposing to mandate the form, specific timing, or method for delivering disclosure pursuant to the Disclosure Obligation, other than the general requirement that the disclosure be made "prior to or at the time of" the recommendation. Instead, we aim to provide broker-dealers flexibility in determining how to satisfy the Disclosure Obligation. As part of that determination, the dual-registrant should consider how best to assist its retail customers in understanding the capacity in which it is acting. For example, dual-registrants could disclose capacity through a variety of means, including, among others, written disclosure at the beginning of a relationship (e.g., in an account opening agreement or account disclosure) that clearly sets forth when the broker-dealer would act in a broker-dealer capacity

and how it will provide notification of any changes in capacity (e.g., "All recommendations will be made in a broker-dealer capacity unless otherwise expressly stated at the time of the recommendation." or "All recommendations regarding your brokerage account will be made in a broker-dealer capacity, and all recommendations regarding your advisory account will be in an advisory capacity. When we make a recommendation to you, we will expressly tell you which account we are discussing and the capacity in which we are acting."). So long as the broker-dealer provides this type of disclosure *in writing* prior to the recommendation, we preliminarily believe that the broker-dealer would not need to provide written disclosure each time it changes capacity or each time it makes a recommendation, provided it makes clear the capacity in which the broker-dealer is acting in accordance with its initial disclosure.<sup>188</sup>

#### (2) Fees and Charges

A broker-dealer's fees and charges that apply to retail customers' transactions, holdings, and accounts would also be examples of items we would generally consider to be "material facts relating to the scope and terms of the relationship." As such, fees and charges would generally fall under the requirement for written disclosure prior to, or at the time of, the recommendation. Fees and charges are important to retail investors,<sup>189</sup> but many retail investors are uncertain about the fees they will pay.<sup>190</sup> Many commenters have stressed the importance of clear fee disclosure to retail investors.<sup>191</sup>

<sup>188</sup> See *infra* note 216 and accompanying text.

<sup>189</sup> See Staff of the Securities and Exchange Commission, Study Regarding Financial Literacy Among Investors as required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Aug. 2012), at iv ("With respect to financial intermediaries, investors consider information about fees, disciplinary history, investment strategy, conflicts of interest to be absolutely essential."), available at <https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf>.

<sup>190</sup> See Rand Study, *supra* note 28, at xix ("In fact, focus-group participants with investments acknowledged uncertainty about the fees they pay for their investments, and survey responses also indicate confusion about the fees.").

<sup>191</sup> See, e.g., Wells Fargo 2017 Letter (recommending disclosure of fees and the scope of activities, among other information, as part of a recommended standard of conduct); ACLI Letter (recommending, among other things, full and fair disclosure of the recommended product's features, fees, and charges, and fairly disclosing how and by whom the financial professional is compensated); SIFMA 2017 Letter (recommending a new broker-dealer standard of conduct being accompanied by

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<sup>187</sup> See *supra* Section II.B.

As described more fully in the Relationship Summary Proposal, the Relationship Summary is designed to provide investors greater clarity concerning the principal fees and charges they should expect to pay and how the types of fees and charges affect the incentives of the firm and their financial professionals.<sup>192</sup> However, the proposed Relationship Summary would focus on general descriptions regarding types of fees and charges, rather than offer a comprehensive or personalized schedule of fees or other information about the amounts, percentages or ranges of fees and charges. Although we are not proposing to mandate the form, specific content or method for delivering fee disclosure, in furtherance of the goal of layered disclosure, to meet the Disclosure Obligation, we would generally expect broker-dealers to build

enhanced up-front disclosure, including information such as the type and scope of services, and the types of compensation the broker-dealer may receive and the customer may pay); UBS 2017 Letter (recommending, in the context of variable compensation received based on a recommendation, an exemption subject to meeting the new standards of conduct and providing a disclosure document (similar to Form ADV) that would include compensation that may be received from clients and from third parties, material conflicts of interest, and the types of compensation for the various products and services available); ICI August 2017 Letter (recommending a best interest standard including, among other provisions, a requirement to disclose certain key aspects of a broker-dealer's relationship with the customer, such as the type and scope of services provided, the applicable standard of conduct, and the types of compensation it or its associated persons receive); State Farm 2017 Letter (recommending a standardized, plain-English disclosure requirement as a part of a standard of conduct, which would include, among other information, the services available and applicable fees); Bernardi Letter (recommending a "standardized, straightforward, and truthful disclosure regime" describing, among other things, all fees and commissions earned (including direct/indirect fees, and pricing discounts received)); Vanguard Letter (recommending a standard including several components such as enhanced disclosure, which would include the nature and scope of the duty owed to clients and the types of direct and indirect compensation to be received, among other things).

<sup>192</sup> As discussed above, broker-dealers are also currently subject to a number of specific disclosure obligations when they effect certain customer transactions, and additional disclosure obligations under the antifraud provisions of the federal securities laws. See *supra* notes 175, 176, 177 and accompanying text. See also Exchange Act Rules 15g-4 and 15g-5 (prior to effecting a penny stock transaction, a broker-dealer generally is required to provide certain disclosures, including the aggregate amount of any compensation received by the broker-dealer in connection with such transaction; and the aggregate amount of cash compensation that any associated person of the broker-dealer has received or will receive from any source in connection with the transaction). Additional fee disclosure requirements are also addressed in SRO guidance. See, e.g., FINRA Regulatory Notice 13-23, Brokerage and Individual Retirement Account Fees (July 2013) (providing guidance on disclosure of fees in communications concerning retail brokerage accounts and IRAs).

upon the Relationship Summary, by disclosing additional detail (including quantitative information, such as amounts, percentages or ranges) regarding the types of fees and charges described in the Relationship Summary.<sup>193</sup>

### (3) Type and Scope of Services

The type and scope of services a broker-dealer provides its retail customers would also be an example of what typically would be "material facts relating to the scope and terms of the relationship," and thus would likely need to be disclosed prior to, or at the time of the recommendation, pursuant to this obligation. More specifically, we believe broker-dealers should, consistent with the goal of layered disclosure, build upon their disclosure in the Relationship Summary, and provide additional information regarding the types of services that will be provided as part of the relationship with the retail customer and the scope of those services.

In particular, in the Relationship Summary, broker-dealers would provide high level disclosures concerning services offered to retail investors, including, for example, recommendations of securities, assistance with developing or executing an investment strategy, monitoring the performance of the retail investor's account, regular communications, and limitations on selections of investments.<sup>194</sup> A broker-dealer that offers different account types, or that offers varying additional services to retail customers may not be able, within the content and space constraints of the Relationship Summary, to provide the "material facts relating to the scope and terms of the relationship" with the retail customer (which may include further detail regarding the specific products and services offered in that retail customer's account,<sup>195</sup> any limitations on those products or services, the frequency and duration of those

services, and the standards of conduct that apply to those services). Pursuant to the Disclosure Obligation, we would generally expect broker-dealers to disclose these types of material facts concerning the actual services offered as part of the relationship with the retail customer (*i.e.*, specific to the type of account held by the retail customer) in a separate document or documents.<sup>196</sup>

### b. Material Conflicts of Interest

The Disclosure Obligation would also explicitly require the broker-dealer to, prior to or at the time of such recommendation, reasonably disclose all material conflicts of interest associated with the recommendation. For purposes of Regulation Best Interest, we propose to interpret a "material conflict of interest" as a conflict of interest that a reasonable person would expect might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested. In determining how to interpret what constitutes a "material conflict of interest," we considered the definition of "material conflict of interest" as used in BIC Exemption and related PTEs.<sup>197</sup> However, we developed this proposed interpretation based on the Advisers Act as we believe it is appropriate to interpret the term in accordance with existing and well-established Commission precedent regarding identification of conflicts of interest for which advisers may face antifraud liability under the Advisers Act in the absence of full and fair disclosure.<sup>198</sup>

We believe that this obligation to disclose should only apply to "material conflicts of interest," and not to "any conflicts of interest" that a broker-dealer may have with the retail customer. Limiting the obligation to "material" conflicts is consistent with case law under the antifraud provisions, which limit disclosure obligations to "material facts," even when a broker-dealer is in

<sup>196</sup> As noted above, we understand that broker-dealers already typically provide some of these disclosures through various means. See *supra* notes 175, 176, 177 and accompanying text.

<sup>197</sup> In the BIC Exemption, a Material Conflict of Interest exists when an Adviser or Financial Institution has a "financial interest that a reasonable person would conclude could affect the exercise of its best judgment as a fiduciary in rendering advice to a Retirement Investor." See BIC Exemption.

<sup>198</sup> See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191–92, 194 (1963), (stating that as part of its fiduciary duty, an adviser must "fully and fairly" disclose to its clients all material information in accordance with Congress's intent "to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested").

<sup>193</sup> Specifically, the Relationship Summary requires high level disclosures (in part, through prescribed statements) concerning broad categories, but not specific amounts, percentages or ranges of transaction-based or other fees (including commissions, mark-ups and mark-downs and sales "loads"), other account fees and expenses (including, for example, custodian, account maintenance and account inactivity fees), and investment fees and expenses for certain products such as mutual funds and variable annuities.

<sup>194</sup> See Relationship Summary Proposal.

<sup>195</sup> Broker-dealers may determine that other services, not included as part of the Relationship Summary, are also "material facts relating to the scope and terms of the relationship," including, for example, margin, cash management, discretionary authority (consistent with the discussion in Section II.F), access to research, etc.

a relationship of trust and confidence with its customer.<sup>199</sup> Limiting disclosure to material conflicts is designed to provide retail customers with full disclosure of key pieces of information regarding those conflicts that may affect a recommendation to a retail customer.<sup>200</sup> We believe that expanding the scope of the obligation more broadly to cover any conflicts a broker-dealer may have would inappropriately require broker-dealers to provide information regarding conflicts that would not ultimately affect a retail customer's decision about a recommended transaction or strategy and might obscure the more important disclosures.

The Disclosure Obligation applies to any "material conflict of interest," including those arising from financial incentives. As discussed below, the proposed Conflict of Interest Obligations would require a broker-dealer to establish, maintain and enforce written policies and procedures reasonably designed to: (1) Identify and at a minimum disclose, or eliminate, all material conflicts of interest associated with the recommendation; and (2) identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with the recommendation. To the extent a broker-dealer determines, pursuant to the Conflict of Interest Obligations, not to eliminate, but to disclose a material conflict of interest, or to disclose and mitigate a material conflict of interest that is a financial incentive, this Disclosure Obligation would apply.

We preliminarily believe that a material conflict of interest that generally should be disclosed would include material conflicts associated with recommending: Proprietary products,<sup>201</sup> products of affiliates, or

<sup>199</sup> See, e.g., *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970) ("[F]ailure to inform the customer fully of its possible conflict of interest, in that it was a market maker in the securities which it strongly recommended for purchase by [plaintiff], was an omission of material fact in violation of Rule 10b-5."); *United States v. Laurienti*, 611 F.3d 530, 541 (9th Cir. 2010) (emphasizing that "even in a trust relationship, a broker is required to disclose only material facts" and that "materiality is defined by the nature of the trust relationship between the clients and the brokers: 'This relationship places an affirmative duty on brokers to use reasonable efforts to give the customer information relevant to the affairs that have been entrusted to them.'") quoting *United States v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002)).

<sup>200</sup> This interpretation is consistent with the 913 Study recommendation. See 913 Study at 112.

<sup>201</sup> See SIFMA 2017 Letter ("Likewise, consistent with our prior written advocacy on this issue, the new standard would not prohibit BDs from offering any of the following, if accompanied by appropriate disclosure, and the product or service is in the best

limited range of products;<sup>202</sup> one share class versus another share class of a mutual fund<sup>203</sup>; securities underwritten by the firm or a broker-dealer affiliate; the rollover or transfer of assets from one type of account to another (such as recommendations to rollover or transfer assets in an ERISA account to an IRA, when the recommendation involves a securities transaction)<sup>204</sup>; and allocation of investment opportunities among retail customers (e.g., IPO allocation). A broker-dealer should also consider whether these conflicts arise from financial incentives that need to be mitigated, as discussed in proposed paragraph (a)(2)(iv).

For the avoidance of doubt, the requirement under Regulation Best Interest that a broker-dealer disclose information about material conflicts of interest is not intended to limit or restrict a broker-dealer's obligations under federal securities laws, including the general antifraud provisions of the federal securities laws, relating to disclosure of additional information to a customer at the time of the customer's investment decision.<sup>205</sup>

interest of the customer: (1) Proprietary products or services (including those from affiliates); (2) transaction charge-based accounts (e.g., commissions); (3) complex products (e.g., structured products, alternative investments such as hedge funds and private equity funds, etc.); and . . .").

<sup>202</sup> Broker-dealers may offer a limited range of products, for instance, products sponsored or managed by an affiliate or products with third-party arrangements (e.g., revenue sharing).

<sup>203</sup> See, e.g., *IFG Network Sec., Inc.*, Exchange Act Release No. 54127 (July 11, 2006) (Commission Decision).

<sup>204</sup> For example, firms and their registered representatives that recommend an investor roll over plan assets to an IRA may earn commissions or other fees as a result, while a recommendation that a retail customer leave his plan assets with his old employer or roll the assets to a plan sponsored by a new employer likely results in little or no compensation for a firm or a registered representative. See FINRA Regulatory Notice 13-45.

<sup>205</sup> See Sections 10(b) and 15(c) of the Exchange Act. See, e.g., Exchange Act Rule 10b-10 (Confirmation of Transactions) Preliminary Note (requiring broker-dealers to disclose specified information in writing to customers at or before completion of the transactions). For example, a broker-dealer may be required to disclose revenue sharing payments that it or its affiliates may receive for distributing fund shares from a fund's investment adviser or others. Those payments provide sales incentives that create conflicts between broker-dealers' financial interests and their agency duties to customers. Revenue sharing payments may lead a broker-dealer to use "preferred lists" that explicitly favor the distribution of certain funds. Revenue sharing payments also may lead to favoritism that is less explicit but just as real, such as through broker-dealer practices allowing funds that make revenue sharing payments to have special access to broker-dealer sales personnel, and through other incentives or instructions that a broker-dealer may provide to managers or salespersons. See, e.g., *In re Edward D. Jones & Co. Securities Act Release No. 8520* (Dec. 22, 2004) (broker-dealer violated antifraud

### c. Guidance on Reasonable Disclosure

We are proposing that the Disclosure Obligation would require a broker-dealer, or natural person who is an associated person of a broker or dealer to "reasonably" disclose material facts, including material conflicts. In lieu of setting explicit requirements by rule for what constitutes effective disclosure, the Commission proposes to provide broker-dealers with flexibility in determining the most appropriate way to meet this Disclosure Obligation depending on each broker-dealer's business practices, consistent with the principles set forth below and in line with the suggestion of some commenters that stressed the importance of allowing broker-dealers to select the form and manner of delivery of disclosure.<sup>206</sup> To facilitate compliance with this Disclosure Obligation, the Commission is providing preliminary guidance, as discussed below, on what it believes would be to "reasonably" disclose in accordance with the Disclosure Obligation by setting forth the aspects of effective disclosure, including the form and manner of disclosure and the timing and frequency of disclosure. While the Commission is providing flexibility with regard to the form and manner of disclosure as well as timing and frequency, the adequacy of disclosure will depend on the facts and circumstances.<sup>207</sup> In order to

provisions of Securities Act and Exchange Act by failing to disclose conflicts of interest arising from receipt of revenue sharing, directed brokerage payments and other payments from "preferred" families that were exclusively promoted by broker-dealer); *In re Morgan Stanley DW Inc.*, Securities Act Release No. 8339 (Nov. 17, 2003) (broker-dealer violated antifraud provisions of Securities Act by failing to disclose special promotion of funds from families that paid revenue sharing and portfolio brokerage).

<sup>206</sup> See TIAA Letter; Bernardi Letter; ACLI Letter. But see UBS Letter; Nationwide Letter; FSR Letter (suggesting the SEC require a disclosure document similar to Form ADV).

<sup>207</sup> For example, the Commission has indicated that failure to disclose the nature and extent of a conflict of interest may violate Securities Act Section 17(a)(2). See *Edward D. Jones & Co., L.P.*, Exchange Act Release No. 50910 (Dec. 22, 2004); *Morgan Stanley DW, Inc.*, Exchange Act Release No. 48789 (Nov. 17, 2003). In the context of scalping, it is misleading to disclose that the person making the investment recommendation "may" trade the recommended securities when in fact the person does so. In *SEC v. Blavin*, for example, the Sixth Circuit held that a newsletter publisher could not avoid liability for scalping under Section 10(b) and Rule 10b-5 of the Exchange Act by disclosing that it "may trade for its own account." 760 F.2d at 709-11. The court found that this was a material misstatement because in fact it did trade for its own account. See *id.*; see also *SEC v. Gane*, 2005 WL 90154 at \*14 (S.D. Fla., Jan. 4, 2005) ("By stating that they, their affiliates, officers, directors, or employees 'may' buy or sell stock in their Investment Opinions, Southern Financial and

“reasonably disclose” in accordance with this Disclosure Obligation, a broker-dealer would need to give sufficient information to enable a retail customer to make an informed decision with regard to the recommendation.<sup>208</sup> Disclosures made pursuant to the Disclosure Obligation must be true and may not omit any material facts necessary to make the required disclosures not misleading.<sup>209</sup>

In addition to providing firms flexibility, we further believe it is important to require that broker-dealers or natural persons who are associated persons of the broker-dealer to “reasonably disclose” so that compliance with the Disclosure Obligation will be measured against a negligence standard, not against a standard of strict liability.<sup>210</sup> In taking this position, we are sensitive to the potential that, if we instead proposed an express obligation that broker-dealers “disclose material facts relating to the scope and terms of the relationship with the retail customer and material conflict of interest,” broker-dealers, in an effort

Strategic investors failed to provide adequate disclosure”).

<sup>208</sup> See, e.g., *De Kwiatkowski*, 306 F.3d 1293, *supra* notes 15 (“the broker . . . is obliged to give honest and complete information when recommending a purchase or sale.”) and 176; see also *Arleen W. Hughes*, Exchange Act Release No. 4048, *supra* note 143 (finding duty to disclose material facts “in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent”).

<sup>209</sup> As noted, Regulation Best Interest applies in addition to any obligations under the Exchange Act, along with any rules the Commission may adopt thereunder, and any other applicable provisions of the federal securities laws and related rules and regulations. For example, any transaction or series of transactions, whether or not subject to the provisions of Regulation Best Interest, remain subject to the antifraud and anti-manipulation provisions of the securities laws, including, without limitation, Section 17(a) of the Securities Act [15 U.S.C. 77q(a)] and Sections 9, 10(b), and 15(c) of the Exchange Act [15 U.S.C. 78i, 78j(b), and 78o(c)] and the rules thereunder.

<sup>210</sup> While we understand that pursuant to the fiduciary duty under the Advisers Act Section 206(1) and (2), an investment adviser must eliminate, or at least disclose, all conflicts of interest, as this duty is derived from the antifraud provisions, it is not a strict liability standard. See *In the Matter of Cranshire Capital Advisors LLC*, Investment Advisers Act Release No. 4277 (Nov. 23, 2015); *SEC v. Capital Gains Research Bureau, Inc.* In particular, scienter is required to establish violations of Section 206(1) of the Advisers Act. *SEC v. Steadman*, 967 F.2d 636, 641 & n.3 (D.C. Cir. 1992). However, scienter is not required to establish a violation of Section 206(2) of the Advisers Act; a showing of negligence is adequate. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963); see also *SEC v. Steadman*, 967 F.2d at 643 & n.5; *Steadman v. SEC*, 603 F.2d 1126, 1132–34 (5th Cir. 1979), *aff’d on other grounds*, 450 U.S. 91 (1981).

The DOL Fiduciary Rule also would avoid strict liability, albeit through a “good faith” exemption in its BIC Exemption. Section II(e)(8), BIC Exemption Release at 21046–21047.

to avoid any inadvertent failure to disclose this information as required, could opt to disclose *all* facts and conflicts (including those that do not meet the materiality threshold). This could result in lengthy disclosures that do not meaningfully convey the material facts and material conflicts of interest and may undermine the Commission’s goal of facilitating disclosure to assist retail customers in making informed investment decisions.

Given the unique structure and characteristics of the broker-dealer relationship with retail customers—including the varying levels and frequency of recommendations that may be provided, and the types of conflicts that may be presented—we believe it is important to provide broker-dealers flexibility in determining the most appropriate and effective way to meet this Disclosure Obligation, consistent with the principles set forth below. Accordingly, at this time we are not proposing to require a standard written document akin to Form ADV Part 2A, as suggested by certain commenters. As discussed in more detail below, we preliminarily believe that while some forms of disclosure may be standardized, certain disclosures may need to be tailored to the particular recommendation, and some disclosures may be addressed through an initial more generalized disclosure about the material fact or conflict, followed by specific disclosure at another point. Accordingly, we have preliminarily determined to provide flexibility in the form and manner, and timing and frequency, of the disclosure.

#### (1) Form and Manner of Disclosure

The Commission believes that disclosure should be concise, clear and understandable to promote effective communication between a broker-dealer and retail customer.<sup>211</sup> Specifically, broker-dealers generally should apply plain English principles to written disclosures including, among other things, the use of short sentences and active voice, and avoidance of legal jargon, highly technical business terms, or multiple negatives.<sup>212</sup> Broker-dealers may also, for example, consider whether the use of graphics could help investors

<sup>211</sup> Exchange Act Section 15(l)(1) and Advisers Act Section 211(h)(1) provide that the Commission shall “facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers and investment advisers, including any material conflicts of interest.”

<sup>212</sup> See Office of Investor Education and Assistance, U.S. Securities and Exchange Commission, *A Plain English Handbook: How to Create Clear SEC Disclosure Documents* (Aug. 1998). See also Relationship Summary Proposal.

better understand and evaluate these disclosures. Additionally, we believe that any such disclosure must be provided in writing in order to facilitate investor review of the disclosure, promote compliance by firms, facilitate effective supervision, and facilitate more effective regulatory oversight to help ensure and evaluate whether the disclosure complies with the requirements of Regulation Best Interest.<sup>213</sup> As with other documents broker-dealers must deliver, broker-dealers would be able to deliver the disclosure required pursuant to Regulation Best Interest consistent with the Commission’s guidance regarding electronic delivery of documents.<sup>214</sup>

As described above, we are not proposing to specify by rule the form (e.g., *narrative v. graphical/tabular, number of pages, etc.*) or manner (e.g., relationship guide or other written communications) of disclosure. Given the variety of ways retail customers may communicate with their broker-dealer, as well as the type of compensation and other conflicts presented and the variety in the frequency and level of advice services provided (*i.e.*, one-time,

<sup>213</sup> We recognize that broker-dealers may provide recommendations by telephone. In such instances, we believe that a broker-dealer could meet its obligation to reasonably disclose “in writing,” “prior to or at the time of such recommendation” through a variety of approaches, as described *infra* in Section II.D.1.c.(2). For example, the broker-dealer may have already provided relevant disclosures prior to the telephone conversation (e.g., in a relationship guide, an account opening agreement or account disclosure). The broker-dealer may also be able to meet the delivery obligation by sending the relevant disclosure electronically (e.g., by email) to the retail customer during the telephone conversation. See also, *infra* note 216 and accompanying text, where we explain that we would not consider the disclosure of capacity at the time of recommendation to also be subject to the “in writing” requirement (*i.e.*, a broker-dealer could clarify it orally, so long as it had previously provided an initial disclosure setting forth when the broker-dealer is acting in a broker-dealer capacity and the method it will use to clarify the capacity in which it is acting at the time of the recommendation).

<sup>214</sup> See generally Use of Electronic Media for Delivery Purposes, Exchange Act Release No. 36345 (Oct. 6, 1995) (“1995 Release”) (providing Commission views on the use of electronic media to deliver information to investors, with a focus on electronic delivery of prospectuses, annual reports to security holders and proxy solicitation materials under the federal securities laws); Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Exchange Act Release No. 37182 (May 9, 1996) (“1996 Release”) (providing Commission views on electronic delivery of required information by broker-dealers, transfer agents and investment advisers); Use of Electronic Media, Exchange Act Release No. 42728 (Apr. 28, 2000) (“2000 Release”) (providing updated interpretive guidance on the use of electronic media to deliver documents on matters such as telephonic and global consent; issuer liability for website content; and legal principles that should be considered in conducting online offerings).

episodic or on a more frequent basis), we believe that some disclosures may be effectively provided in a standardized document at the beginning of the relationship, whereas others may need to be tailored to a particular recommendation. Accordingly, we preliminarily believe that broker-dealers should have the flexibility to make disclosures by various means (*e.g.*, different types of disclosure documents), as opposed to requiring a single standard written document. As noted, however, whether there is sufficient disclosure will depend on the facts and circumstances.

## (2) Timing and Frequency of Disclosure

The Disclosure Obligation would apply “prior to or at the time of” the recommendation. The timing of the disclosure is critically important to whether it may achieve the effect contemplated by the proposed rule. Investors should receive information early enough in the process to give them adequate time to consider the information and promote the investor’s understanding in order to make informed investment decisions, but not so early that the disclosure fails to provide meaningful information (*e.g.*, does not sufficiently identify material conflicts presented by a particular recommendation, or overwhelms the retail customer with disclosures related to a number of potential options that the retail customer may not be qualified to pursue). The timing of the required disclosure should also reflect the various ways in which retail customers may receive recommendations and convey orders.<sup>215</sup>

In light of these goals, we would like to emphasize the importance of determining the appropriate timing and frequency of disclosure that may be effectively provided “prior to or at the time of” the recommendation, but which may be achieved through a variety of approaches: (1) At the beginning of a relationship (*e.g.*, in a relationship guide, such as or in addition to the Relationship Summary, or in written communications with the retail customer, such as the account opening agreement); (2) on a regular or periodic basis (*e.g.*, on a quarterly or annual basis, when any previously disclosed information becomes materially inaccurate, or when there is new relevant material information); (3) at other points, such as before making a particular recommendation or at the point of sale; and/or (4) at multiple points in the relationship or through a

layered approach to disclosure. For example, a broker-dealer may determine that certain disclosures may be most effective if they are made at multiple points in the relationship, or, if pursuant to a layered approach to disclosure, certain material facts are conveyed in a more general manner in an initial written disclosure and followed by more specific information in a subsequent disclosure, which may be at the time of the recommendation<sup>216</sup> or even after the recommendation (*i.e.*, in the trade confirmation). Disclosure after the recommendation, such as in a trade confirmation for a particular recommended transaction would not, by itself, satisfy the Disclosure Obligation, because the disclosure would not be “prior to, or at the time of the recommendation.” However, a broker-dealer could satisfy the Disclosure Obligation, depending on the facts and circumstances, if the initial disclosure, in addition to conveying material facts relating to the scope and terms of the relationship with the retail customer, explains when and how a broker-dealer would provide additional more specific information regarding the material fact or conflict in a subsequent disclosure (*e.g.*, disclosures in a trade confirmation concerning when the broker-dealer effects recommended transactions in a principal capacity). We believe that including in the general disclosure this additional information of when and how more specific information will be provided would help the retail customer understand the general nature of the information provided and alert the retail customer that more detailed information about the fact or conflict would be provided and the timing of such disclosure.<sup>217</sup> As noted above, whether

<sup>216</sup> For example, as discussed above in the discussion of the disclosure of the capacity in which the broker-dealer is acting, a broker-dealer may take this type of approach with respect to meeting its obligation regarding the capacity in which it is acting at the time of the recommendation. As noted above, we preliminarily believe that a broker-dealer would satisfy the Disclosure Obligation expressly by providing written disclosure setting forth when the broker-dealer is acting in a broker-dealer capacity versus an advisory capacity and how the broker-dealer will clarify when it is making a recommendation whether it is doing so in a broker-dealer capacity versus an advisory capacity. However, one important distinction is that the written disclosure requirement would apply to the initial disclosure (*i.e.*, setting forth when the broker-dealer is acting in a broker-dealer capacity and the method it will use to clarify the capacity in which it is acting at the time of the recommendation), but we would not consider the subsequent disclosure of capacity at the time of recommendation to also be subject to the “in writing” requirement (*i.e.*, a broker-dealer could clarify it orally).

<sup>217</sup> The Commission has granted exemptions to certain dual registrants, subject to a number of conditions, from the written disclosure and consent

there is sufficient disclosure in both the initial disclosure and any subsequent disclosure, will depend on the facts and circumstances.

The Commission anticipates that broker-dealers may elect to make certain required disclosures of information to their customers at the beginning of a relationship, such as in a relationship guide, account agreement, comprehensive fee schedule, or other written document accompanying such documents. While certain forms of disclosure may be standardized, certain disclosures may need to be tailored to a particular recommendation, for example, if the standardized disclosure does not sufficiently identify the material conflicts presented by the particular recommendation. Furthermore, additional disclosure may be needed beyond the standardized disclosure (such as an account agreement) when any previously provided information becomes materially inaccurate, or when there is new relevant material information (*e.g.*, a new material conflict of interest has arisen that is not addressed by the standardized disclosure). Because the Disclosure Obligation would apply “prior to or at the time of” the recommendation, if a broker-dealer has previously made the relevant disclosure to the retail customer (and there have been no material changes to the previously disclosed information), it would not be expected to repeat such disclosure at each subsequent recommendation, depending on the facts and circumstances of the prior disclosure. As noted above, we would like to emphasize the importance of determining the appropriate timing and frequency of disclosure. For example, where a significant amount of time passes between the disclosure and a recommendation, the broker-dealer generally should determine whether the retail customer should reasonably be

requirements of Advisers Act Section 206(3) (which makes it unlawful for an adviser to engage in a principal trade with an advisory client, unless it discloses to the client in writing before completion of the transaction the capacity in which the adviser is acting and obtains the consent of the client to the transaction). The exemptions are subject to several conditions, including conditions to provide disclosures at multiple points in the relationship, including disclosure that the entity may be acting in a principal capacity in a written confirmation at or before completion of a transaction. *See, e.g.*, In the matter of Merrill Lynch Pierce Fenner & Smith, Incorporated, Investment Advisers Act Release No. 4595 (Dec. 28, 2016); In the matter of Robert W. Baird & Co., Incorporated, Investment Advisers Act Release No. 4596 (Dec. 28, 2016); In the matter of UBS Financial Services, Inc., Investment Advisers Act Release No. 4597 (Dec. 28, 2016); In the matter of Wells Fargo Advisors, LLC, Wells Fargo Advisors Financial Network, LLC, Investment Advisers Act Release No. 4598 (Dec. 28, 2016).

<sup>215</sup> *See, e.g.*, note 160 *supra*, describing “check and application” arrangements.



expected to be on notice of the prior disclosure; if not, the broker-dealer generally should not rely on such disclosure.

The Commission preliminarily believes this flexible approach to disclosure is consistent with the broker-dealers' liabilities or obligations under the antifraud provisions of the federal securities laws.<sup>218</sup>

#### d. Consistency With Other Approaches

We believe that the proposed Disclosure Obligation, in conjunction

<sup>218</sup> For example, generally, under the antifraud provisions, whether a broker-dealer has a duty to disclose material information to its customer depends upon the scope of the relationship with the customer, which is fact-intensive. *See, e.g., Conway v. Icahn & Co., Inc.*, 16 F.3d 504, 510 (2d Cir. 1994) (“A broker, as agent, has a duty to use reasonable efforts to give its principal information relevant to the affairs that have been entrusted to it.”). Where a broker-dealer processes its customer's orders, but does not recommend securities or solicit customers, then the material information that the broker-dealer is required to disclose to its customer is narrow, encompassing only the information related to the consummation of the transaction. *See Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 536 (2d Cir. 1999). In such circumstances, the broker-dealer generally does not have to provide information regarding the security or the broker-dealer's economic self-interest in the security. *See, e.g., Carras v. Burns*, 516 F.2d 251, 257 (4th Cir. 1975) (broker-dealer not required to volunteer advice where “acting only as a broker”); *Canizaro v. Kohlmeier & Co.*, 370 F. Supp. 282, 289 (E.D. La. 1974), *aff'd*, 512 F.2d 484 (5th Cir. 1975) (broker-dealer that “merely received and executed a purchase order, has a minimal duty, if any at all, to investigate the purchase and disclose material facts to a customer”); *Walston & Co. v. Miller*, 410 P.2d 658, 661 (Ariz. 1966) (“The agency relationship between customer and broker normally terminates with the execution of the order because the broker's duties, unlike those of an investment advisor or those of a manager of a discretionary account, are only to fulfill the mechanical, ministerial requirements of the purchase and sale of the security or future contract on the market.”).

*See also* Exchange Act Rule 10b-10 (“Rule 10b-10”). Rule 10b-10 requires a broker-dealer effecting customer transactions in securities (other than U.S. savings bonds or municipal securities) to provide written notification to the customer, at or before completion of the transaction, disclosing information specific to the transaction, including whether the broker-dealer is acting as agent or principal and its compensation, as well as any third-party remuneration it has received or will receive. Exchange Act Rules 15c1-5 and 15c1-6 also require a broker-dealer to disclose in writing to the customer if it has any control, affiliation, or interest in a security it is offering or the issuer of such security. The Commission and the SROs have also adopted rules designed to address conflicts of interest that can arise when security analysts recommend equity securities in research reports and public appearances. *See* Regulation Analyst Certification, or Regulation AC. Regulation AC requires that broker-dealers include certifications by the research analyst in research reports and disclose whether or not the research analyst received compensation or other payments in connection with his or her specific recommendations or reviews. *See also* FINRA Rule 2241 (imposing requirements on FINRA members to address conflicts of interest relating to the publication and distribution of equity research reports).

with the Relationship Summary and Regulatory Status Disclosure noted above is consistent with many of the principles underlying the disclosure recommendation regarding disclosure in the 913 Study and behind the disclosure obligations of the BIC Exemption—which we believe is to facilitate disclosure and retail customer understanding of the key information material to a retail customer's relationship with a broker-dealer, including the scope and terms of the relationship and material conflicts of interest—and provides much of the same information, but in a less prescriptive manner that is designed to provide firms flexibility in how to satisfy the obligation.

Specifically, broker-dealers relying on the BIC Exemption to provide investment advice to retirement accounts would need to do so pursuant to a written contract that includes specific language and disclosures, including, among others, provisions: Acknowledging fiduciary status; committing the firm and the adviser to adhere to standards of impartial conduct; and warranting the adoption of policies and procedures reasonably designed to ensure that advisers provide best interest advice and minimize the harmful impact of conflicts of interest. The firm would also need to disclose information on the firm's and advisers' conflicts of interest and the cost of their advice and provide certain ongoing web disclosures.<sup>219</sup>

As previously noted, the 913 Study recommended that the Commission engage in rulemaking and/or issue interpretive guidance on the components of the recommended uniform fiduciary standard: The duties of loyalty and care.<sup>220</sup> With respect to disclosure obligations under the Duty of Loyalty, the 913 Study recommended the Commission facilitate the provision of uniform, simple, and clear disclosures to retail customers about the terms of the relationships with broker-dealers and investment advisers, including any material conflicts of interest. The 913 Study also recommended that the Commission consider disclosures that should be provided (a) in a general relationship guide akin to Form ADV Part 2A and (b) more specific disclosures at the time of providing investment advice, as well as consider the utility and feasibility of a summary disclosure document containing key information on a firm's services, fees, and conflicts and the scope of its services. Finally, the 913

Study recommended the Commission consider whether rulemaking would be appropriate to prohibit certain conflicts, to require firms to mitigate conflicts through specific action, or to impose specific disclosure and consent requirements.<sup>221</sup>

We believe that our proposed Disclosure Obligation, in conjunction with the Relationship Summary and Regulatory Status Disclosure noted above, would address many of the underlying concerns of and would provide customers with substantially similar information as required under the BIC Exemption and recommended in the 913 Study.

The Disclosure Obligation under Regulation Best Interest further builds on and complements the Relationship Summary and Regulatory Status Disclosure and together, these obligations would clarify the capacity in which a firm or financial professional is acting, in an effort to minimize investor confusion, and facilitate greater awareness of key aspects of a relationship with a firm or financial professional through a layered approach to disclosure.

#### e. Request for Comment on Proposed Disclosure Obligation

The Commission generally requests comment on the Disclosure Obligation. In addition, the Commission requests comment on the following specific issues:

- Would the Disclosure Obligation cause a broker-dealer to act in a manner that is consistent with what a retail customer would reasonably expect from someone who is required to act in his or her best interest? Why or why not?
- Should the Commission require new disclosure, beyond that which is currently required pursuant to common law, and Exchange Act and SRO rules?
- Should the Commission promulgate more specific disclosure requirements such as written account disclosure akin to Form ADV Parts 2A and 2B?
- Should the Commission require a specific type or amount of disclosure? What criteria should determine or inform the type or amount of disclosure?
- Should the Commission explicitly require that the disclosure be “full and fair”? Why or why not?
- Should the Commission require broker-dealers to “reasonably disclose” as proposed? Should the Commission provide additional guidance as to how broker-dealers can meet that standard? If so, what additional guidance would commenters recommend? Should the

<sup>219</sup> *See* BIC Exemption.

<sup>220</sup> *See* 913 Study at 112.

<sup>221</sup> *See* 913 Study at 114–18.

Commission consider a different approach, such as a “good faith” exemption? Why or why not?

- Do commenters believe that the Disclosure Obligation requires disclosure of information that investors would not find useful? If so, please specify what information and why.

- Is there additional information that investors would find useful? If so, please specify what information and why.

- The Commission requests comment on existing broker-dealer disclosure practices. Do broker-dealers currently provide disclosures that could satisfy this requirement? If so, what types of disclosures and when/how are they delivered? Do broker-dealers provide customer-specific disclosures indicating what type of account is held and in what capacity the firm is acting? If so, how are those disclosures made (e.g., on account statements) and at what time(s)? How do broker-dealers provide disclosures when making recommendations on the phone? Do all broker-dealers provide such disclosures, or only some broker-dealers? If only some, how many and under what circumstances? Are those disclosures written and presented in a manner consistent with the preliminary guidance on disclosure in this release? Please provide examples.

- Do broker-dealers currently provide more detailed disclosures than contemplated to be required as part of the Relationship Summary regarding the nature and scope of services provided, as well as the legal obligations and duties that apply to those services? If so, how and when is such disclosure provided (e.g., in the account agreement or other document)? Please provide examples. To what extent do retail customers read and/or understand these disclosures? How effective are these disclosures and how consistent are they with the plain language and other principles of reasonable disclosure described above? How would we ensure that any disclosures are understood by retail investors?

- Would the Relationship Summary achieve the goal of the Disclosure Obligation of facilitating the retail customer’s awareness of the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest associated with the recommendation without the additional Disclosure Obligation? Should the Commission consider permitting broker-dealers to satisfy their obligations under this requirement solely by delivering the proposed Relationship Summary? Do commenters believe the Relationship

Summary would ever fulfill the Disclosure Obligation? When would it? When would it not?

- The Commission has identified certain topics that would generally be considered material facts relating to the scope and terms of the relationships (i.e., capacity, fees and services). Do commenters have examples of other information relating to scope and terms of the relationship that should be highlighted by the Commission as likely to be considered material facts that would need to be disclosed? If so, please provide examples. Should the Commission provide further guidance on such additional material facts? Should the Commission articulate these specific material facts (e.g., capacity, fees and services) as required disclosures in the rule text (e.g., by defining “material facts relating to the scope and terms of the relationship”)? Why or why not?

- Should the Commission require additional disclosures for dual-registrants, as suggested above, because the Relationship Summary and Regulatory Status Disclosure for dual-registrants would describe both brokerage and advisory services/capacities?

- Should the Commission articulate additional requirements or guidance for a dual-registrant to satisfy the Disclosure Obligation? If so, what additional requirements or guidance and why? Should dual-registrants be required to disclose, in writing, each time they change capacity?

- The Commission proposes to provide flexibility to a broker-dealer that is a dual-registrant to determine how to disclose that it is acting in a broker-dealer capacity. How do commenters anticipate that dual-registrants will meet this obligation? Specifically, how do commenters expect dual-registrants to meet the obligation to provide such disclosure “prior to or at the time of” a recommendation in their capacity as a broker-dealer? Should a broker-dealer be required to make a customer-specific or recommendation-specific disclosure about the capacity in which it is acting? Should that disclosure be made on a one-time or ongoing basis? Should the Commission mandate the form or method of delivery of that disclosure? For example, should the Commission require broker-dealers to include the disclosure in account opening forms or periodic statements or in other documents?

- Does the guidance concerning additional more detailed disclosures that broker-dealers should consider providing in furtherance of layered disclosure cause confusion about the

level of disclosure firms are required to make in order to satisfy the requirement to disclose the terms and scope of the relationship? If so, how could the Commission clarify this guidance? Would the layered disclosure approach cause confusion among retail customers?

- The Commission requests comment on existing broker-dealer practices concerning fee disclosures. What types of fee disclosures do broker-dealers currently provide? Do broker-dealers currently provide fee disclosures that could satisfy this requirement? If so, what types of disclosures and when/how are they delivered? Do broker-dealers provide customer-specific disclosures indicating what type of fees are charged, how they are identified (e.g., on account statements?), and when/if they change? Please provide examples.

- Should the Commission mandate the form, specific content or method for delivering fee disclosure? Why or why not? Do commenters believe that disclosure of fees in a uniform manner would be beneficial for investors? If so, what would be the preferred style of such disclosure in order to facilitate investor comprehension of such fees?

- The Commission preliminarily believes that broker-dealers should be required to disclose, at a minimum, the types of fees that are included in the Relationship Summary. Should the Commission provide more clarity regarding what types of fees should be disclosed? Should the Commission add a materiality threshold for fee disclosure?

- Should the Commission mandate a comprehensive fee schedule? Why or why not? If so, should the Commission mandate the form, specific content or method of delivering the comprehensive fee schedule?

- Should broker-dealers be required to update fee disclosures 30 days or another specified time period before they raise fees or impose new fees? Should this requirement be limited to material fees? How should such fees be defined?

- Should broker-dealers be required to use specified terms to describe certain material fees? If so, what should those specified terms be?

- As proposed, the rule only requires disclosure to retail customers who receive recommendations. Should the Commission consider requiring fee disclosure to all retail customers, including customers in self-directed brokerage accounts? Why or why not?

- Would self-directed customers benefit from more detailed fee disclosure? If so, in what form should

the disclosure to self-directed customers be provided, and what should be the scope of fee information provided?

- Regarding timing of disclosure, the Commission preliminarily believes that the disclosure should be made “prior to or at the time of” the recommendation. Should the Commission consider a different timing requirement? For example, should the Commission require disclosure “immediately prior to the recommendation”? Should the Commission instead mandate the timing and frequency of certain disclosures? If so, which disclosures should be subject to more specific timing or updating requirements? For example, should the Commission require annual delivery of certain disclosure, such as fee disclosures? Why or why not?

- Do commenters agree that in certain circumstances broker-dealers should be permitted to provide an initial disclosure followed by more specific disclosure after the recommendation? Why or why not? Do commenters require more guidance on when this would be permitted? If so, how could the Commission clarify this guidance?

- Are there services, in addition to those provided as examples, that should be considered material facts relating to the scope of terms of the relationships? If so, please explain. Are there specific types of services that broker-dealers provide that should be required to be disclosed? If so, which ones?

- Should the Commission require specific disclosures on products and product limitations? Why or why not?

- Should broker-dealers be subject to more specific requirements concerning the method of disclosures? If so, what additional requirements should the Commission consider, and why? If not, why not? For example, should the Commission impose requirements concerning prominence or method of delivery?

- Do commenters believe that all disclosures should be made in writing, as proposed? Should the Commission permit disclosures to be made orally, so long as a written record of the oral disclosure is made and retained?

- Should the Commission require that certain disclosures be made prior to the execution of a transaction? If so, which ones? Why or why not?

- Should broker-dealers be required to make certain disclosures before the first recommendation or transaction effected for a customer? If so, which ones? Why or why not?

- Are there any specific interactions or relationships between the disclosure requirements under the Disclosure Obligation and the Relationship Summary that should be addressed?

- Are there any specific interactions or relationships between the disclosure requirements under the Disclosure Obligation and the Conflict of Interest Obligations that should be addressed?

- Are there any specific interactions or relationships between the disclosure requirements in Regulation Best Interest and the existing general antifraud provisions that should be addressed? Do commenters believe the general antifraud provisions adequately address other non-recommendation related conflicts or should Regulation Best Interest also cover such conflicts?

The Commission requests comment on the proposed requirement to disclose all material conflicts of interest associated with the recommendation.

- Should the Commission require such disclosures?

- Should the Commission use a different interpretation for what is a “material conflict of interest”? If so, which one and why?

- Should the Commission define “material conflicts of interest” in terms of an incentive that causes a broker-dealer not to act in the retail customer’s best interest? Why or why not?

- Are there any types of material conflicts that commenters believe the Commission should require to be disclosed? If so, which ones and why?

- Are there any material conflicts of interest that commenters believe cannot be disclosed sufficiently in writing? If so, which conflicts and why?

- Should the Commission require a specific type or amount of disclosure? What criteria should determine or inform the type or amount of disclosure?

- Should the disclosure requirements include quantification of conflicts of interest, the economic benefits from material conflicts of interest to firms and their associated persons, or the costs of such conflicts to retail customers or clients?

- Given the number of dually-registered representatives, would the existence of written disclosure in Form ADV Part 2B, including disclosure about financial incentives such as conflicts from compensation received in association with a broker-dealer, in the absence of comparable written disclosure expressly relating to other conflicts that may affect the same representative’s recommendations in a broker-dealer capacity, create a misleading impression about the representative’s conflicts or their potential impact on advice in a broker-dealer rather than an adviser capacity?

- Are there particular material conflicts arising from financial incentives or other material conflicts

that the Commission should specifically require a broker-dealer to disclose to a retail customer? If so, which ones and why? If not, why not? Are there any for which the Commission should specifically require advance customer written consent? If so, which and why?

## 2. Care Obligation

The Commission proposes to require, as part of Regulation Best Interest, a Care Obligation that would require a broker-dealer, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, to exercise reasonable diligence, care, skill, and prudence to: (1) Understand the potential risks and rewards 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; (2) 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 and rewards associated with the recommendation; and (3) have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer’s best 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. These proposed obligations would require a broker-dealer making a recommendation of a securities transaction or investment strategy involving securities to a retail customer to have a reasonable basis for believing that the recommended transaction or investment strategy is in the best interest of the retail customer and does not put the financial or other interest of the broker-dealer before that of the retail customer.<sup>222</sup> The Care Obligation is intended to incorporate and enhance existing suitability requirements applicable to broker-

<sup>222</sup> Under Regulation Best Interest, as proposed, a broker-dealer’s duty to exercise reasonable diligence, care, skill and prudence is designed to be similar to the standard of conduct that has been imposed on broker-dealers found to be acting in a fiduciary capacity. *See, e.g., Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1215 (8th Cir. 1990) (the district court did not abuse its discretion in instructing the jury that licensed securities brokers were fiduciaries that owed their customers a duty of utmost good faith, integrity and loyalty); *see also Paine, Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d 508, 515–16 (Colo. 1986) (evidence “that a customer has placed trust and confidence in the broker” by giving practical control of account can be “indicative of the existence of a fiduciary relationship”); *SEC v. Ridenour*, 913 F.2d 515 (8th Cir. 1990) (bond dealer owed fiduciary duty to customers with whom he had established a relationship of trust and confidence).

dealers under the federal securities laws by, among other things, imposing a “best interest” requirement which we would interpret to require the broker-dealer not put its own interest ahead of the retail customer’s interest, when making recommendations.<sup>223</sup>

Although the term “prudence” is not a term frequently used in the federal securities laws,<sup>224</sup> the Commission believes that this term conveys the fundamental importance of conducting a proper evaluation of any securities recommendation in accordance with an objective standard of care. However, recognizing that the term “prudence” is generally not used under the federal securities laws, we also seek comment below on whether there is adequate clarity and understanding regarding its usage, or whether other terms are more appropriate in the context of broker-dealer regulation.

Under the Care Obligation, a broker-dealer generally should consider reasonable alternatives, if any, offered by the broker-dealer in determining whether it has a reasonable basis for making the recommendation. This approach would not require a broker-dealer to analyze all possible securities, all other products, or all investment strategies to recommend the single “best” security or investment strategy for the retail customer, nor necessarily require a broker-dealer to recommend the least expensive or least remunerative security or investment strategy.<sup>225</sup> Nor does Regulation Best Interest prohibit, among others, recommendations from a limited range of products, or recommendations of proprietary products, products of affiliates, or principal transactions, provided the Care Obligation is satisfied and the associated conflicts are

<sup>223</sup> In response to Chairman Clayton’s Statement, several commenters supporting a best interest standard for broker-dealers suggested that the best interest standard be built upon existing broker-dealer requirements, such as suitability, and include enhancements to those standards as the Commission sees necessary. See, e.g., SIFMA 2017 Letter, John Hancock Letter; Fidelity Letter; Wells Fargo Letter; ICI August 2017 Letter. See also *supra* Section II.B.

<sup>224</sup> But see *SEC v. Glt Dain Rauscher, Inc.*, 254 F.3d 852, 853 (9th Cir. 2001) (where, in the context of an underwriter of municipal offerings who allegedly violated several federal securities laws, the court held “that the industry standard of care for an underwriter of municipal offerings is one of reasonable prudence, for which the industry standard is one factor to be considered, but is not the determinative factor”). In addition, under Section 11(c) of the Securities Act [15 U.S.C. 77k(c)], the adequacy of an underwriter’s due diligence efforts and, in turn, its ability to establish a due diligence defense is determined by “the standard of reasonableness [that] shall be that required of a prudent man in the management of his own property” (emphasis added).

<sup>225</sup> See *supra* Section II.B.

disclosed (and mitigated, as applicable) or eliminated, as discussed in Sections II.B. and II.D.2.

a. Understand the Potential Risks and Rewards of the Recommended Transaction or Strategy, and Have a Reasonable Basis To Believe That the Recommendation Could Be in the Best Interest of at Least Some Retail Customers

Broker-dealers must deal with their customers fairly<sup>226</sup>—and, as part of that obligation, have a reasonable basis for any recommendation.<sup>227</sup> This obligation stems from the broker-dealer’s “special relationship” to the retail customer, and from the fact that in recommending a security or investment strategy, the broker-dealer represents to the customer “that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation.”<sup>228</sup>

Paragraph (a)(2)(ii)(A) of proposed Regulation Best Interest, which is intended to incorporate a broker-dealer’s existing obligations under “reasonable-basis suitability,”<sup>229</sup> would

<sup>226</sup> See, e.g., *Duker & Duker*, Exchange Act Release No. 2350, at \*2, 6 SEC. 386, 388 (Dec. 19, 1939) (Commission opinion) (“Inherent in the relationship between a dealer and his customer is the vital representation that the customer be dealt with fairly, and in accordance with the standards of the profession.”). See also Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H. Doc. 95, 88th Cong., 1st Sess., at 238 (1963) (“An obligation of fair dealing, based upon the general antifraud provisions of the Federal securities laws, rests upon the theory that even a dealer at arm’s length impliedly represents when he hangs out his shingle that he will deal fairly with the public.”).

<sup>227</sup> See *Mac Robbins & Co.*, Exchange Act Release No. 6846, at \*3 (“[T]he making of representations to prospective purchasers without a reasonable basis, couched in terms of either opinion or fact and designed to induce purchases, is contrary to the basic obligation of fair dealing borne by those who engage in the sale of securities to the public.”), *aff’d sub nom.*, *Berko v. SEC*, 316 F.2d 137 (2d Cir. 1963).

<sup>228</sup> See *Hanly*, 415 F.2d 596–97 (“A securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents that he has an adequate and reasonable basis for the opinions he renders.”); *In the Matter of Lester Kuznetz*, 1986 WL 625417 at \*3, Exchange Act Rel. No. 23525 (Aug. 12, 1986) (Commission opinion) (“When a securities salesman recommends securities, he is under a duty to ensure that his representations have a reasonable basis.”); see also FINRA Regulatory Notice 10–22, *Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings* (Apr. 2010).

<sup>229</sup> The courts, the Commission, and FINRA have interpreted the broker-dealer’s existing reasonable-basis suitability obligation to impose a broad affirmative duty to have an “adequate and reasonable basis” for any recommendation that they make. See, e.g., *Hanly*, 415 F.2d 597; see also *SEC v. Hasho*, 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992) (“By making a recommendation, a securities dealer implicitly represents to a buyer of securities that he has an adequate basis for the recommendation.”);

require a broker-dealer to “exercise reasonable diligence, care, skill, and prudence to . . . [u]nderstand the potential risks and rewards 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.”<sup>230</sup> This obligation would relate to the particular security or strategy recommended, rather than to any particular retail customer.<sup>231</sup> Without establishing such a threshold understanding of its particular recommendation, we do not believe that a broker-dealer could, as required by Regulation Best Interest, act in the best interest of a retail customer when making a recommendation.

To meet this proposed requirement under paragraph (a)(2)(ii)(A), a broker-dealer would need to: (1) Undertake reasonable diligence (*i.e.*, reasonable investigation and inquiry) to understand the potential risks and rewards of the recommended security or strategy (*i.e.*, to understand the security or strategy), and (2) have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers based on that

*Michael Frederick Siegel*, Exchange Act Rel. No. 58737, at \*12–13 (Oct. 6, 2008) (Commission opinion) (“The suitability rule . . . requires that . . . a registered representative must first have an ‘adequate and reasonable basis’ for believing that the recommendation could be suitable for at least some customers.”); *Terry Wayne White*, Exchange Act Rel. No. 27895, at \*4, 50 SEC. 211, 212 & n.4 (1990) (Commission opinion) (“It is well established that a broker cannot recommend any security to a customer ‘unless there is an adequate and reasonable basis for such recommendation. . . .’”).

<sup>230</sup> Reasonable-basis suitability “requires that a representative ensure that he or she has an ‘adequate and reasonable’ understanding of an investment before recommending it to customers.” *Richard G. Cody*, Exchange Act Release No. 64565, at \*12 (May 27, 2011) (Commission opinion, sustaining FINRA findings) (citing *Hanly*, 415 F.2d at 597).

This understanding must include the “‘potential risks and rewards’ and potential consequences of such recommendation.” See *Richard G. Cody*, Exchange Act Release No. 64565, at \*12 (May 27, 2011) (Commission opinion, sustaining FINRA findings) (internal citations omitted), *aff’d*, *Cody v. SEC*, 693 F.3d 251 (1st Cir. 2012); *F.J. Kaufman and Co. of Virginia and Frederick J. Kaufman, Jr.*, Exchange Act Release No. 27535, at \*3, 50 SEC. 164 (Dec. 13, 1989) (Commission opinion, sustaining NASD findings) (“[A] broker cannot determine whether a recommendation is suitable for a specific customer unless the broker understands the potential risks and rewards inherent in that recommendation.”). See also FINRA Regulatory Notice 11–02 (Jan. 2011).

<sup>231</sup> See *Michael Frederick Siegel*, Exchange Act Release No. 58737, at \*12–13 (Oct. 6, 2008) (Commission opinion, sustaining NASD findings), *aff’d in relevant part*, *Siegel v. SEC*, 592 F.3d 147 (D.C. Cir. 2010), *cert. denied*, 560 U.S. 926 (2010).

understanding.<sup>232</sup> A broker-dealer must adhere to both components to meet its obligation under proposed paragraph (a)(2)(ii)(A).<sup>233</sup> Thus, a broker-dealer could violate the obligation if he or she did not understand the potential risks and rewards of the recommended security or investment strategy, even if the security or investment strategy could have been in the best interest for at least *some* retail customers.<sup>234</sup> In addition, if a broker-dealer understands the recommended security or investment strategy, he or she must still have a reasonable basis to believe that the security or investment strategy could be in the best interest of at least *some* retail customers.<sup>235</sup>

In general, what would constitute reasonable diligence under proposed paragraph (a)(2)(ii)(A) will vary depending on, among other things, the

<sup>232</sup> See paragraph (a)(2)(ii)(A) of Proposed Regulation Best Interest; see also *Cody v. SEC*, 693 F.3d 251, 259 (1st Cir. 2012) (finding that registered representative was responsible for investigating security that he recommended and failed to have sufficient understanding of security); *F.J. Kaufman*, Exchange Act Release No. 27535, at \*3 (“A broker-dealer in his dealings with customers impliedly represents that his opinions and predictions respecting a [security] which he has undertaken to recommend are responsibly made on the basis of actual knowledge and careful consideration . . . .”); see also FINRA Regulatory Notice 12–25 at Q22.

<sup>233</sup> See FINRA Rule 2110.05(a). See also FINRA Regulatory Notice 12–25 at Q22 (the “reasonable-basis obligation has two components: A broker must (1) perform reasonable diligence to understand the nature of the recommended security or investment strategy involving a security or securities, as well as the potential risks and rewards, and (2) determine whether the recommendation is suitable for at least some investors based on that understanding”). In discussing SRO suitability rules, the Commission has noted that “the ‘reasonable-basis’ test is subsumed within the [NASD’s] suitability rule. A broker cannot conclude that a recommendation is suitable for a particular customer unless he has a reasonable basis for believing that the recommendation could be suitable for at least some customers.” *Terry Wayne White*, Exchange Act Release No. 27895, at \*2, 50 SEC. 211, 212–13 (Apr. 11, 1990) (Commission opinion, sustaining NASD findings) (citing *F.J. Kaufman*, Exchange Act Release No. 27535).

<sup>234</sup> See FINRA Regulatory Notice 12–25 at Q22 (noting that the “reasonable-basis obligation is critically important because, in recent years, securities and investment strategies that brokers recommend to customers, including retail investors, have become increasingly complex and, in some cases, risky. Brokers cannot fulfill their suitability responsibilities to customers (including both their reasonable-basis and customer-specific obligations) when they fail to understand the securities and investment strategies they recommend. . . .”). Broker-dealers also have additional specific suitability obligations with respect to certain types of products or transactions, such as variable insurance products and non-traditional products, including structured products and security futures. See, e.g., FINRA Rule 2330, “Members’ Responsibilities Regarding Deferred Variable Annuities;” FINRA Rule 2370, “Security Futures;” see also 913 Study at 65–66.

<sup>235</sup> See FINRA Regulatory Notice 12–25 at Q22.

complexity of and risks associated with the recommended security or investment strategy and the broker-dealer’s familiarity with the recommended security or investment strategy.<sup>236</sup> For example, the cost associated with a recommendation is ordinarily only one of many factors to consider when evaluating the risks and rewards of a subject security or investment strategy involving securities. Other factors may include, but are not limited to, the investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, and likely performance of market and economic conditions, the expected return of the security or investment strategy, as well as any financial incentives to recommend the security or investment strategy.

While every inquiry will be specific to the broker-dealer and the investment or investment strategy, broker-dealers may wish to consider questions such as:

- Can less costly, complex, or risky products available at the broker-dealer achieve the objectives of the product?
- What assumptions underlie the product, and how sound are they? What market or performance factors determine the investor’s return?
- What are the risks specific to retail customers? If the product was designed mainly to generate yield, does the yield justify the risk to principal?
- What costs and fees for the retail customer are associated with this product? Why are they appropriate? Are all of the costs and fees transparent? How do they compare with comparable products offered by the firm?
- What financial incentives are associated with the product, and how will costs, fees, and compensation relating to the product impact an investor’s return?
- Does the product present any novel legal, tax, market, investment, or credit risks?
- How liquid is the product? Is there a secondary market for the product?<sup>237</sup>

This list of questions is not meant to be comprehensive, nor should it substitute for a broker-dealer’s own assessment of what factors should be considered to determine the risks and rewards of a particular investment or investment strategy. However, it is meant to illustrate the types of questions and considerations a broker-dealer generally should consider when developing an understanding of the

<sup>236</sup> See FINRA Rule 2111.05(a).

<sup>237</sup> See NASD Notice to Members 05–26, New Products—NASD Recommends Best Practices for Reviewing New Products (Apr. 2005).

potential risks and rewards associated with a recommendation, and when developing a reasonable basis to believe that the recommended investment or investment strategy could be in the best interest of at least *some* retail customers.<sup>238</sup> If a broker-dealer cannot establish such a fundamental understanding of its recommendation (*i.e.*, the risks and rewards associated with the recommendation, or that the recommendation could be in the best interest of at least some retail customers), we do not believe that the broker-dealer could establish that it is acting in a retail customer’s best interest when making a recommendation in accordance with proposed paragraph (a)(2)(ii)(B) of Regulation Best Interest.

#### b. Reasonable Basis To Believe the Recommendation Is in the Best Interest of a Particular Retail Customer

Beyond establishing an understanding of the recommended securities transaction or investment strategy, we believe that acting in the best interest of the retail customer would require a broker-dealer to have a reasonable basis to believe that a specific recommendation is in the best interest of the *particular* retail customer based on its understanding of the investment or investment strategy under proposed paragraph (a)(2)(ii)(A), and in light of the retail customer’s investment objectives, financial situation, and needs. Accordingly, under proposed paragraph (a)(2)(ii)(B), the second obligation would require a broker-dealer to “exercise reasonable diligence, care, skill, and prudence to . . . 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 and rewards associated with the recommendation.” Under this standard, a broker-dealer could not have a reasonable basis to believe that the recommendation is in the “best interest” of the retail customer, if the broker-dealer put its interest ahead of the retail customer’s interest, as discussed in Section II.B.

For the reasons set forth below, this proposed obligation is intended to incorporate a broker-dealer’s existing well-established obligations under “customer-specific suitability,”<sup>239</sup> but

<sup>238</sup> See *supra* note 233.

<sup>239</sup> See, e.g., *J. Stephen Stout*, Exchange Act Release No. 43410, at \*11, 54 SEC. 888, 909 (Oct. 4, 2000) (Commission opinion) (“As part of a broker’s basic obligation to deal fairly with customers, a broker’s recommendation must be suitable for the client in light of the client’s investment objectives, as determined by the client’s financial situation and needs.”); *Richard N. Cea*,

enhances these obligations by requiring that the broker-dealer have a reasonable basis to believe that the recommendation is in the “best interest” of (rather than “suitable for”) the retail customer. After extensive consideration of these existing customer-specific suitability requirements, we believe that it is appropriate to generally draw and build upon this existing obligation, as noted below, as the contours of the obligation are well-defined, and this approach would promote consistency and clarity in the relevant obligations, and facilitate the development of compliance policies and procedures for broker-dealers while also promoting investor protection.

Thus, under proposed Regulation Best Interest, the broker-dealer will be required to have a reasonable basis to believe, based on its diligence and understanding of the risks and rewards of the recommendation, and in light of the retail customer’s investment profile, that the recommendation is in the best interest of the retail customer and does not place the broker-dealer’s interest ahead of the customer’s interest. We believe this will enhance the quality of recommendations, and will improve investor protection by minimizing the potential harmful impacts that broker-dealer conflicts of interest may have on recommendations provided to retail customers.

As described above, the broker-dealer’s diligence and understanding of the risks and rewards would generally involve consideration of factors, such as the costs, the investment objectives and characteristics associated with a product or strategy (including any special or

unusual features, liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions), as well as the financial and other benefits to the broker-dealer.<sup>240</sup> Thus, in forming a reasonable basis to believe that the recommended securities transaction or investment strategy is in the best interest of a particular retail customer, and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer, the broker-dealer would generally need to consider these specific product or strategy related factors, as relevant—and in particular the financial and other benefits to the broker-dealer—along with the customer’s investment profile (as described below). While the Commission believes these are all important considerations in analyzing any recommendation made by a broker-dealer, they are critical considerations in analyzing whether a recommendation with respect to a particular retail customer’s “best interest.”

Under the existing “customer specific suitability” obligation, to determine whether an investment recommendation is suitable for the customer when evaluated in terms of the investor’s financial situation, tolerance for risk, and investment objectives, broker-dealers have a duty to seek to obtain relevant information from customers relating to their financial situations and to keep such information current.<sup>241</sup>

The Commission also proposes to include this concept of a “customer’s investment profile,” consistent with FINRA’s suitability rule.<sup>242</sup> Specifically, the proposed rule would provide that the “*Retail Customer Investment Profile* includes, but is not limited to, the retail customer’s age, other investments, financial situation and needs, tax status,

investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation.”<sup>243</sup> A broker-dealer would be required to exercise “reasonable diligence” to ascertain the retail customer’s investment profile as part of satisfying proposed paragraph (a)(2)(i)(B).<sup>244</sup> When retail customer information is unavailable despite a broker-dealer’s reasonable diligence to obtain such information, a broker-dealer would have to consider whether it has sufficient understanding of the retail customer to properly evaluate whether the recommendation is in the retail customer’s best interest.<sup>245</sup> A broker-dealer that makes a recommendation to a retail customer for whom it lacks sufficient information to have a reasonable basis to believe that the recommendation is in the best interest of that retail customer based on the retail customer’s investment profile would not meet its obligations under the proposed rule.<sup>246</sup>

For clarification, in keeping with the requirement that a securities-related recommendation must be in the best interest of the customer at the time it is made, a broker-dealer generally should make a reasonable effort to ascertain information regarding an existing customer’s investment profile prior to the making of a recommendation on an “as needed” basis—*i.e.*, where a broker-dealer knows or has reason to believe that the customer’s investment profile has changed.<sup>247</sup> The reasonableness of a

Exchange Act Release No. 8662, at \*7 (Aug. 6, 1969) (Commission opinion) (“It was incumbent on the salesman in these circumstances, as part of their basic obligation to deal fairly with the investing public, to make only such recommendations as they had reasonable grounds to believe met the customers’ expressed needs and objectives.”). Both courts and the Commission have found broker-dealers or their registered representatives liable for making unsuitable recommendations based on violations of the antifraud provisions of the federal securities laws. See *Brown v. E.F. Hutton Group*, 991 F.2d 1020, 1031 (2d Cir. 1993) (“[a]nalytically, an unsuitability claim is a subset of the ordinary Section 10(b) fraud claim”); *O’Connor v. R.F. Lafferty & Co.*, 965 F.2d 893 (10th Cir. 1992); *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 599–600 (2d Cir. 1978); *Steven E. Louros v. Kreicas*, 367 F. Supp. 2d 572, 585 (S.D.N.Y. 2005); *Mauriber v. Shearson/American Express, Inc.*, 567 F. Supp. 1231 (S.D.N.Y. 1983); *Steven E. Muth and Richard J. Rouse*, Exchange Act Release No. 52551, 58 SEC. 770 (Oct. 3, 2005) (Commission opinion). FINRA’s suitability rule also imposes a customer-specific suitability obligation on broker-dealers. See FINRA Rule 2111.05(b) (“The customer-specific obligation requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer’s investment profile, as delineated in Rule 2111(a).”).

<sup>240</sup> See *supra* Section II.D.2.a (providing examples of various factors that could be considered when evaluating the risks and rewards of a recommended investment or investment strategy).

<sup>241</sup> See *Gerald M. Greenberg*, Exchange Act Release No. 6320, at \*3, 40 SEC. 133, 137–38 (July 21, 1960) (Commission opinion, sustaining NASD findings) (holding that a broker-dealer cannot avoid the duty to make suitable recommendations simply by avoiding knowledge of the customer’s financial situation). Under FINRA’s suitability rule, the broker-dealer has a duty to undertake reasonable diligence to ascertain the customer’s investment profile. FINRA Rule 2111(a) (“A customer’s investment profile includes, but is not limited to, the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.”); FINRA Regulatory Notice 12–25 at Q15–Q21 (discussing broker-dealer’s information-gathering requirements).

<sup>242</sup> *Id.*

<sup>243</sup> See paragraph (c)(2) of Proposed Regulation Best Interest.

<sup>244</sup> See FINRA Regulatory Notice 12–25 at Q16 (outlining what constitutes “reasonable diligence” in attempting to obtain customer-specific information and that the reasonableness of the effort also will depend on the facts and circumstances). See also FINRA Regulatory Notice 11–25, Know Your Customer and Suitability (May 2011) (“FINRA Regulatory Notice 11–25”).

<sup>245</sup> See FINRA Regulatory Notice 11–25 at Q3. While “neglect, refusal, or inability of the retail customer to provide or update any information” would excuse the broker, dealer, or associated person from obtaining the information under proposed Rule 17a–3(a)(25) discussed in Section II.E., it would not relieve a broker-dealer of its obligation to determine whether it has sufficient information to properly evaluate whether a recommendation is in the retail customer’s best interest.

<sup>246</sup> See FINRA Regulatory Notice 12–25 at Q16 (outlining what constitutes “reasonable diligence” in attempting to obtain customer-specific information and that the reasonableness of the effort also will depend on the facts and circumstances).

<sup>247</sup> We note that, pursuant to Exchange Act rules, a broker-dealer must submit to an existing customer

broker-dealer's effort to collect information regarding a customer's investment profile information depends on the facts and circumstances of a given situation, and the importance of each factor may vary depending on the facts and circumstances of the particular case.<sup>248</sup> Generally, however, absent information that would cause a broker-dealer to know or have reason to know that the information contained in a customer's investment profile is inaccurate, a broker-dealer may reasonably rely on the information in an existing customer's investment profile.

We believe our proposed definition of "retail customer investment profile" identifies appropriate factors that should be considered as part of evaluating a recommendation and whether it is in a retail customer's best interest, because the factors generally are relevant to a determination regarding whether a recommendation is in the best interest of a particular customer (*i.e.*, does the recommendation comport with the retail customer's investment profile). Furthermore, by applying a consistent definition across existing suitability requirements and proposed Regulation Best Interest, we hope to provide clarity to broker-dealers and maintain efficiencies for broker-dealers that have already established infrastructures to comply with their suitability obligations when making recommendations. Finally, we note that this definition would be consistent with the factors the DOL identified for consideration as part of a best interest recommendation under the BIC Exemption: "the investment objectives, risk tolerance, financial circumstances and needs" of a retirement investor.<sup>249</sup>

We propose to interpret the customer-specific obligation in paragraph (a)(2)(ii)(B) of proposed Regulation Best Interest consistent with existing precedent, rules and guidance, but

his or her account record or alternative document to explain any terms regarding investment objectives for accounts in which the member, broker or dealer has been required to make a suitability determination within the past 36 months. The account record or alternative document must include or be accompanied by prominent statements on which the customer should mark any corrections and return the account record or alternate document to the broker-dealer, and the customer should notify the broker-dealer of any future changes to information contained in the account record—including the customer's investment objectives. See CFR 240.17a-3(a)-17(i)(A), (B)(i), (B)(iii), (D). The accompanying discussion in the text addresses circumstances where a broker-dealer generally should make reasonable efforts to ascertain a customer's investment profile information prior to this 36-month period.

<sup>248</sup> See FINRA Regulatory Notice 12-25 at Q16.

<sup>249</sup> See Best Interest Contract Exemption, 81 FR 21002 (Apr. 8, 2016).

subject to the enhanced "best interest" (rather than "suitability") standard. Thus, as noted above, when considering the factors that comprise a retail customer's investment profile, the broker-dealer would be required to consider whether it has sufficient information regarding the customer to properly evaluate whether a recommendation is in the best interest of the retail customer without placing the financial or other interest of the broker-dealer ahead of that particular retail customer's interests.<sup>250</sup> As such, the level of importance of each factor would depend on the facts and circumstances of a particular recommendation. One or more factors may have more or less relevance—or may not be obtained or analyzed at all—if the broker-dealer has a reasonable basis to believe that the factors are not relevant in light of the facts and circumstances of a particular situation.<sup>251</sup> For example, a broker-dealer may conclude that liquidity needs are irrelevant regarding all customers for whom only liquid securities will be recommended.<sup>252</sup>

We reiterate that we recognize that it may be consistent with a retail customer's investment objectives—and in many cases, in a retail customer's best interest—for a retail customer to allocate investments across a variety of investment products, or to invest in riskier or more costly products, such as some actively managed mutual funds, variable annuities, and structured products. However, in recommending such products, a broker-dealer must satisfy its obligations under proposed Regulation Best Interest. Such recommendations would continue to be evaluated under a fact specific analysis based on the security or investment strategy recommended in connection with the retail customer's investment profile, consistent with the proposed best interest obligation.

In addition, as discussed above under the proposed obligation in paragraph (a)(2)(ii)(A), we emphasize that the costs and financial incentives associated with a recommendation would generally be one of many important factors—including other factors such as the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions—to consider when determining whether a recommended

<sup>250</sup> See FINRA Rule 2111.04.

<sup>251</sup> *Id.*

<sup>252</sup> See FINRA Regulatory Notice 11-25 at Q3.

security or investment strategy involving a security or securities is in the best interest of the retail customer.<sup>253</sup> Thus, where, for example, a broker-dealer is choosing among identical securities available to the broker-dealer, it would be inconsistent with the Care Obligation to recommend the more expensive alternative for the customer.<sup>254</sup> Similarly, we believe it would be inconsistent with the Care Obligation if the broker-dealer made the recommendation to a retail customer in order to: Maximize the broker-dealer's compensation (*e.g.*, commissions or other fees); further the broker-dealer's business relationships; satisfy firm sales quotas or other targets; or win a firm-sponsored sales contest.

We preliminarily believe that, under this prong of the Care Obligation, when a broker-dealer recommends a *more expensive* security or investment strategy over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable basis to believe that the higher cost is justified (and thus nevertheless is in the retail customer's best interest) based on other factors (*e.g.*, the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions), in light of the retail customer's investment profile. When a broker-dealer recommends a *more remunerative* security or investment strategy over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable basis to believe that—putting aside the broker-dealer's financial incentives—the recommendation was in the best interest of the retail customer based on the factors noted above, in light of the retail customer's investment profile. Nevertheless, this does not mean that a broker-dealer could not recommend the more remunerative of two reasonably available alternatives, if the broker-dealer determines the products are otherwise both in the best interest of—and there is no material difference between them from the perspective of—retail customer, in light of the retail customer's investment profile.

Furthermore, we do not believe a broker-dealer could meet its Care Obligation through disclosure alone. Thus, for example, where a broker-dealer is choosing among identical securities with different cost structures,

<sup>253</sup> See discussion *supra* Section II.D.

<sup>254</sup> See *supra* note 106, and accompanying text.

we believe it would be inconsistent with the best interest obligation for the broker-dealer to recommend the more expensive alternative for the customer, even if the broker-dealer had disclosed that the product was higher cost and had policies and procedures reasonably designed to mitigate the conflict under the Conflict of Interest Obligations, as the broker-dealer would not have complied with its Care Obligation.<sup>255</sup> Such a recommendation, disclosure aside, would still need to be in the best interest of a retail customer, and we do not believe it would be in the best interest of a retail customer to recommend a higher-cost product if all other factors are equal.

### c. Reasonable Basis To Believe a Series of Recommended Transactions Is Not Excessive and Is in the Retail Customer's Best Interest

The third obligation would require a broker-dealer to exercise reasonable diligence, care, skill, and prudence to have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best 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. The proposed requirement is intended to incorporate and enhance a broker-dealer's existing obligations under the federal securities laws and incorporate and go beyond FINRA's concept of "quantitative suitability." We believe it is appropriate to incorporate this existing, well-established obligation, which would similarly promote consistency and clarity regarding this obligation. However, we believe it is appropriate to expand the scope of this requirement by applying it irrespective of whether a broker-dealer exercises actual or *de facto* control over a customer's account, thereby making the obligation consistent with the current requirements for "reasonable basis suitability" and "customer specific suitability." Accordingly, Regulation Best Interest would include the existing "quantitative suitability" obligation, but without a "control" element.

Pursuant to the federal securities laws, broker-dealers can violate the federal antifraud provisions by engaging in excessive trading<sup>256</sup> that amounts to churning, switching, or unsuitable recommendations. Churning occurs when a broker-dealer, exercising control over the volume and frequency of

trading in a customer account, abuses the customer's confidence for the broker-dealer's personal gain by initiating transactions that are excessive in view of the character of the account and the customer's investment objectives.<sup>257</sup> Switching occurs when a broker-dealer induces a customer to liquidate his or her shares in a mutual fund or annuity in order to purchase shares in another mutual fund or annuity, for the purpose of increasing the broker-dealer's compensation, where the benefit to the customer of the switch is not justified by the cost of switching.<sup>258</sup> The Commission has also found excessive trading as a suitability violation on the basis that "the frequency of trading must also be suitable."<sup>259</sup> As noted above, FINRA's suitability rule also includes a similar concept known as quantitative suitability.<sup>260</sup>

Under the proposed rule, a broker-dealer must have a reasonable basis to believe that a series of recommended transactions is not excessive. Although

<sup>257</sup> See *Carras v. Burns*, 516 F.2d 251, 258 (4th Cir. 1975). The elements of a churning claim brought under the antifraud provisions include: (1) Excessive trading in the account that was unjustified in light of the customer's investment objectives; (2) the broker-dealer exercised actual or *de facto* control over the trading in the account; and (3) the broker-dealer acted with intent to defraud or with willful or reckless disregard for the customer's interests. See *Rizek v. SEC*, 215 F.3d 157, 162 (1st Cir. 2000). A broker-dealer churning a customer account may be liable under both Exchange Act Section 10(b) and Rule 10b-5 thereunder, and/or Exchange Act Section 15(c), Rules 15c1-2 and/or 15c1-7. See, e.g., *McNeal v. Paine, Webber, Jackson & Curtis, Inc.*, 598 F.2d 888, n.1 (2d Cir. 1979) (noting that churning is illegal under the Exchange Act Sections 15(c)(1) and 10(b) and Rule 10b-5).

<sup>258</sup> See, e.g., *Russell L. Irish*, 42 SEC. 735, 736-40 (1965), *aff'd*, *Irish v. SEC*, 367 F.2d 637 (9th Cir. 1966), *cert. denied*, 386 U.S. 911 (1967).

<sup>259</sup> *Edgar B. Alacan*, Exchange Act Release No. 49970, at \*20, 57 SEC. 715, 736 (July 6, 2004) (Commission opinion) (quoting Sandra K. Simpson and Daphne Ann Pattee, Exchange Act Release No. 45923, at \*13, 55 SEC. 766, 793-794 (May 14, 2002) (Commission opinion)). See *J. Stephen Stout*, Exchange Act Release No. 43410, at \*13, 54 SEC. 888, 912 (Oct. 4, 2000) (Commission opinion) (finding turnover in customer account was unsuitable given customers' investment goals and needs).

<sup>260</sup> See FINRA Rule 2111.05(c) ("Quantitative suitability requires a member or associated person who has actual or *de facto* control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule 2111(a)."). Unlike churning, a violation of quantitative suitability does not require a showing of wrongful intent. See *Cody v. SEC*, 693 F.3d 251, 260 (1st Cir. 2012) ("[W]hile subjective intent is relevant to churning charges under the antifraud regulation of Rule 10b-5, . . . NASD's suitability rule is violated when a representative engages in excessive trading relative to a customer's financial needs . . . regardless of motivation . . .").

no single test defines excessiveness, the following factors may provide a basis for determining that a series of recommended transactions is excessive: turnover rate,<sup>261</sup> cost-to-equity ratio,<sup>262</sup> and use of in-and-out trading<sup>263</sup> in a customer's account. Consideration of turnover rate, cost-to-equity ratio and use of in-and-out trading is consistent with some of the ways the Commission, the courts, and FINRA have historically

<sup>261</sup> The turnover rate, which is the number of times during a given period that securities in an account are replaced by new securities, is a frequently used measure of excessive trading. Turnover rate is calculated by "dividing the aggregate amount of purchases in an account by the average monthly investment. The average monthly investment is the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration." *Shearson Lehman Hutton Inc.*, 49 SEC. 1119, 1122 n.10 (1989). Annual turnover rates as low as three may trigger liability for excessive trading. See, e.g., *Laurie Jones Canady*, 54 SEC. 65, 74 (1999), Exchange Act Release No. 41250 (Apr. 5, 1999) (annual turnover rates ranging from 3.83 to 7.28 times held excessive); *petition denied*, 230 F.3d 362 (DC Cir. 2000); *Donald A. Roche*, 53 SEC. 16, 22 (1997) (annual turnover rates of 3.3, 4.6, and 7.2 times held excessive); *Gerald E. Donnelly*, 52 SEC. 600, Exchange Act Release No. 36690 (Jan. 5, 1996) (annual turnover rates ranging from 3.1 to 3.8 times held excessive); *John M. Reynolds*, 50 SEC. 805 (1991) (annual turnover rate of 4.81 times held excessive). See also *Dep't of Enforcement v. Cody*, No. 2005003188901, 2010 FINRA Discip. LEXIS 8 (NAC May 10, 2010) (same), *aff'd*, Exchange Act Rel. No. 64565, 2011 SEC LEXIS 1862, at \*48 (May 27, 2011) (finding turnover rate of three provided support for excessive trading); *Dep't of Enforcement v. Stein*, No. C07000003, 2001 NASD Discip. LEXIS 38, at \*17 (NAC Dec. 3, 2001) ("Turnover rates between three and five have triggered liability for excessive trading"). The Commission has stated that, "[a]lthough no turnover rate is universally recognized as determinative of churning, a rate in excess of 6 is generally presumed to reflect excessive trading," especially if the customer's objective is conservative. *Al Rizek*, 54 SEC. 261 (1999), Exchange Act Release No. 41725 (Aug. 11, 1999), *aff'd*, *Rizek v. SEC*, 215 F.3d 157 (1st Cir. 2000). See also *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 490 (6th Cir. 1990); *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 767 F.2d 1498, 1502 (11th Cir. 1985).

<sup>262</sup> The cost-to-equity ratio represents "the percentage of return on the customer's average net equity needed to pay broker-dealer commissions and other expenses." *Rafael Pinchas*, 54 SEC. 331, 340 (1999), 1999 SEC LEXIS 1754, at \*18 (Commission review of NASD disciplinary proceeding). Cost-to-equity ratios as low as 8.7 have been considered indicative of excessive trading, and ratios above 12 generally are viewed as very strong evidence of excessive trading. See *Cody*, 2011 SEC LEXIS 1862, at \*49 & \*55 (finding cost-to-equity ratio of 8.7 percent excessive); *Thomas F. Bandyk*, Exchange Act Rel. No. 35415, 1995 SEC LEXIS 481, at \*2-3 (Feb. 24, 1995) ("His excessive trading yielded an annualized commission to equity ratio ranging between 12.1% and 18.0%.").

<sup>263</sup> In-and-out trading refers to the "sale of all or part of a customer's portfolio, with the money reinvested in other securities, followed by the sale of the newly acquired securities." *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1369 n.9 (7th Cir. 1983). A broker's use of in-and-out trading ordinarily is a strong indicator of excessive trading. *Id.*

<sup>255</sup> *Id.*

<sup>256</sup> Excessive trading is a level of trading unjustified in light of the customer's investment objectives. See *Mihara v. Dean Witter & Co., Inc.*, 619 F.2d 814, 821 (9th Cir. 1980).



evaluated whether trading activity is excessive.<sup>264</sup> These factors can be indicative of the magnitude of investor harm caused by the accumulation of high trading costs.

The proposed rule would enhance a broker-dealer's existing obligations in two ways. First, the proposed rule would create a new, explicit obligation under the Exchange Act that a broker-dealer have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customer's best interest when taken together. As noted, the Commission has found unsuitable recommendations of a series of transactions on the basis that the "frequency of trading" was not suitable.<sup>265</sup> Similarly, FINRA's quantitative suitability rule requires the broker-dealer to have a reasonable basis for believing that a series of recommended transactions is not excessive and *unsuitable* for the customer when taken together in light of the customer's investment profile.<sup>266</sup> The proposed rule, instead, would require a broker-dealer to have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customer's *best interest* when taken together in light of the retail customer's investment profile. What would constitute a "series" of recommended transactions would depend on the facts and circumstances. Notably, here this would mean a reasonable basis to believe that the series of recommended transactions is in the best interest of the retail customer based on factors other than the broker-dealer's financial incentive to recommend a series of transactions, as discussed above, and in light of the retail customer's investment profile, consistent with (a)(1).<sup>267</sup>

Second, the proposed rule would require a broker-dealer to have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customer's best interest, regardless of whether the broker-dealer has actual or *de facto* control over a retail customer account. Currently, to prove a churning claim under the antifraud provisions of the Exchange Act, courts and the Commission have interpreted the federal securities laws to require that the broker-dealer exercise actual or *de facto* control over a customer's

account.<sup>268</sup> Similarly, FINRA's quantitative suitability rule only applies to a member or associated person who has actual or *de facto* control over a customer account.<sup>269</sup>

The Commission believes that a broker-dealer should have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best 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, consistent with subparagraph(a)(1). We believe that imposing this requirement without a "control" element would provide consistency in the investor protections provided to retail customers by this proposed paragraph (a)(2)(ii)(C) by requiring a broker-dealer to always form a reasonable basis as to the recommended frequency of trading in a retail customer's account—irrespective of whether the broker-dealer "controls" or exercises "*de facto* control" over the retail customer's account. Moreover, it would also take a consistent approach with the other aspects of the proposed Care Obligation, which apply regardless of whether a broker-dealer "controls" or exercises "*de facto* control" over the retail customer's account. Finally, by removing the control element, the Commission believes the enhanced requirement generally should expand the scope of retail customers that could benefit from the protections of this requirement: specifically, protection from a broker-dealer recommending a level of trading that is so excessive that the resulting cost-to-equity ratio or turnover rate makes a positive return virtually impossible.<sup>270</sup> Thus, the fact that a customer may have *some* knowledge of financial markets or *some* "control" should not absolve the broker-dealer of its ultimate responsibility to have a reasonable basis for any recommendations that it makes.<sup>271</sup> We believe that when a broker-dealer is recommending a series of transactions to the retail customer the broker-dealer must, consistent with paragraph (a)(1), evaluate whether the series of recommendations is placing the broker-

dealer's interests ahead of the retail customer's. Thus, even in instances where a broker-dealer would not be considered to "control" or exercise "*de facto* control" over the retail customer's account, the broker-dealer should be required to comply with proposed paragraph (a)(2)(ii)(C).

#### d. Consistency With Other Approaches

##### (1) DOL Fiduciary Rulemaking

By requiring a broker-dealer that is making a recommendation to a retail customer to act in the retail customer's best interest without placing the broker-dealer's interests ahead of the retail customer's interest, which is satisfied (in part) by the broker-dealer exercising "reasonable diligence, care, skill, and prudence," we believe the proposed Care Obligation generally reflects similar underlying principles as the "objective standards of care" that are incorporated in the best interest Impartial Conduct Standard as set forth by the DOL in the BIC Exemption.<sup>272</sup>

As noted above, the DOL stated that the best interest Impartial Conduct Standard is intended to "incorporate the objective standards of care and undivided loyalty," that require adherence to a professional standard of care in making investment recommendations that are in the investor's best interest, and not basing recommendations on the advice-giver's own financial interest in the transaction, nor recommending an investment unless it meets the objective prudent person standard of care.<sup>273</sup> Proof of fraud or misrepresentation is not required, and full disclosure is not a defense to making an imprudent recommendation or favoring one's own interest at the investor's expense.<sup>274</sup>

Focusing on the "professional standard of care" or "duty of prudence," the DOL explains that the "prudence" standard, as incorporated in the "best interest" standard set forth in the BIC Exemption, is "an objective standard of care that requires investment advice fiduciaries to investigate and evaluate

<sup>268</sup> See *supra* note 257.

<sup>269</sup> See *supra* note 260.

<sup>270</sup> See, e.g., *In re Michael Bresner, et al.*, 2013 WL 5960690, at \*112–115, ID-Rel. No. 517 (Nov. 8, 2013) (finding, *inter alia*, that some registered representatives did not churn certain customers' accounts because they did not exercise *de facto* control where one customer had declined recommendations "a handful of times" and another customer had picked stocks "based on information he may have heard on the radio" and made shadow trades of the same stocks that the representative had recommended).

<sup>271</sup> See *id.*

<sup>272</sup> The BIC Exemption requires that advice be in a retirement investor's best interest, and further defines advice to be in the "best interest" if the person providing the advice acts "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with the such matters would use . . . without regard to the financial or other interests" of the person. BIC Exemption Section II(c)(1); Section VIII (d). The DOL stated this standard is based on longstanding concepts derived from ERISA and the law of trusts, and to "require[s] fiduciaries to put the interests of trust beneficiaries first, without regard to the fiduciaries' own self-interest." BIC Exemption Release, 81 FR 21007, 21027.

<sup>273</sup> *Id.* at 21028.

<sup>274</sup> *Id.*

<sup>264</sup> See also *supra* notes 256, 257, 259, 261, 262, 263. See, e.g., FINRA Regulatory Notice 12–25 at 14, 28–29.

<sup>265</sup> See *supra* note 259.

<sup>266</sup> See *supra* note 260.

<sup>267</sup> See discussion *supra* Section II.D.

investments, make recommendations, and exercise sound judgment in the same way that knowledgeable and impartial professionals would.”<sup>275</sup> The fiduciary must adhere to an objective professional standard and is subject to a particularly stringent standard of prudence when they have a conflict of interest.<sup>276</sup>

Our proposed Care Obligation establishes an objective, professional standard of conduct for broker-dealers that requires broker-dealers to “exercise reasonable diligence, care, skill and prudence to” understand the potential risks and rewards associated with their recommendation and have a reasonable basis to believe that it could be in the best interest of at least some retail customers, have a reasonable basis to believe that the recommendation is in a particular retail customer’s best interest based on that retail customer’s investment profile and the risks and rewards associated with the recommendation, and have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer’s best 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. Moreover, as noted above, this Care Obligation cannot be satisfied through full disclosure, and proof of fraud or misrepresentation would also not be required.

In addition, the Commission believes that the incorporation and enhancement of existing broker-dealer suitability obligations as part of the proposed care obligation would address many of the concerns that were raised by the DOL as a rationale for not referring to the existing FINRA suitability standard as the basis for the best interest obligation under the Impartial Conduct Standards.<sup>277</sup> The proposed Care Obligation incorporates and builds upon existing broker-dealer suitability obligations, as discussed above. Again,

<sup>275</sup> BIC Exemption Release, 81 FR at 21028.

<sup>276</sup> *Id.*

<sup>277</sup> Although DOL did not specifically incorporate the suitability obligation as an element of the “best interest” standard, as suggested by FINRA, the DOL stated “that many aspects of suitability are also elements of the Best Interest Standard” and that a “recommendation that is not suitable under the securities laws would not” meet the standard. But, the DOL identified the following concerns with the current FINRA suitability standard: That it does not “reference a best interest standard, clearly require brokers to put their client’s interest ahead of their own, expressly prohibit the selection of the least suitable (but most remunerative) of available investments, or require them to take the kind of measures to avoid or mitigate conflicts of interest that are required as conditions of this exemption.” BIC Exemption Release, 81 FR 21007, 21027–28.

while not the only factors or sole determinants, cost and the broker-dealer’s financial incentives would be important factors—of many, including the financial and other benefits to the broker-dealer—in determining whether a recommendation is in the best interest.<sup>278</sup> We preliminarily believe that, in order to meet its Care Obligation, when a broker-dealer recommends a security or investment strategy over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable belief that the recommendation was in the best interest of the retail customer based on such other factors, in light of the retail customer’s investment profile. Furthermore, as discussed in the Conflict of Interest Obligations below, proposed Regulation Best Interest requires broker-dealers to take steps to eliminate or mitigate material conflicts of interest arising from financial incentives.

## (2) 913 Study

Further, we believe that the proposed Care Obligation is also similar to the recommended duty of care in the 913 Study. As previously noted, the 913 Study recommended that the Commission engage in rulemaking and/or issue interpretive guidance on the components of the recommended uniform fiduciary standard: the duties of loyalty and care.<sup>279</sup> With respect to the duty of care, the 913 Study recommended that the Commission should consider specifying uniform standards for the duty of care owed to retail investors, through rulemaking and/or interpretive guidance. The 913 Study noted that minimum baseline professionalism standards could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to an investor (*i.e.*, suitability requirements).<sup>280</sup> Further, the 913 Study suggested that the Commission could articulate and harmonize any such professionalism standards for broker-dealers and investment advisers, by referring to and expanding upon, as appropriate, the explicit minimum standards of conduct relating to the duty of care currently applicable to broker-dealers (*e.g.*, suitability, best execution, and fair pricing and compensation requirements).<sup>281</sup> The 913 Study stated that the standards could also take into

<sup>278</sup> See discussion *infra* Section II.D.

<sup>279</sup> See 913 Study at 112.

<sup>280</sup> *Id.* at 123.

<sup>281</sup> *Id.* at 122.

account Advisers Act principles related to the duty of care.<sup>282</sup>

As part of the proposed care obligation under Regulation Best Interest, we are only proposing an obligation with respect to the basis a broker-dealer must have in making a recommendation to a retail customer, and are not proposing the other aspects of the duty of care that are specified in the 913 Study—notably best execution and fair pricing and compensation requirements—as the Commission does not believe that it is necessary to do so at this time. As noted in the 913 Study,<sup>283</sup> broker-dealers currently are subject to explicit standards of conduct relating to best execution<sup>284</sup> and fair and reasonable compensation,<sup>285</sup> and preliminarily we do not believe that enhancements to these obligations are required in connection with this proposal.

Moreover, the 913 Study noted that the staff’s recommendation to specify these aspects of the duty of care was partly based on the need to provide guidance to both investment advisers and broker-dealers of their obligations under the recommended uniform fiduciary duty.<sup>286</sup> In particular, the Study recognized that “detailed guidance” regarding the duty of care, and particularly the duty to provide suitable investment advice “has not been a traditional focus of the investment adviser regulatory regime.”<sup>287</sup> In a concurrent release, we are providing interpretive guidance that reaffirms—and in some cases clarifies—certain aspects of the fiduciary duty that an investment adviser owes to its

<sup>282</sup> *Id.* at 123. See also Fiduciary Duty Interpretive Release, discussing, among other things, investment advisers’ duty of care.

<sup>283</sup> See 913 Study at 121.

<sup>284</sup> Under the antifraud provisions of the federal securities laws and SRO rules, broker-dealers also have a legal duty to seek to obtain best execution of customer orders, which requires broker-dealers to seek to execute customers’ trades at the most favorable terms reasonably available under the circumstances. See, *e.g.*, *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 269–70 (3d Cir.), *cert. denied*, 525 U.S. 811 (1998); *Certain Market Making Activities on Nasdaq*, Exchange Act Release No. 40900 (Jan. 11, 1999) (citing *Sinclair v. SEC*, 444 F.2d 399 (2d Cir. 1971); *Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948) (Commission Opinion), *aff’d sub nom. Hughes v. SEC*, 174 F.2d 969 (DC Cir. 1949). See also *Order Execution Obligations*, Exchange Act Release No. 37619A (Sept. 6, 1996) (“Order Handling Rules Release”). See also Regulation NMS, Exchange Act Release No. 51808 (June 9, 2005) (“Regulation NMS Release”); FINRA Rule 5310 (“Best Execution and Interpositioning”).

<sup>285</sup> FINRA Rule 2121 (“Fair Prices and Commissions”).

<sup>286</sup> See 913 Study at 122–23.

<sup>287</sup> *Id.* at 123.

clients.<sup>288</sup> As the proposed Regulation Best Interest is not based on the Advisers Act and would not apply to investment advisers, but rather is a new standard that would be unique to broker-dealers, taking into consideration the existing requirements of the broker-dealer regulatory regime, the Commission preliminarily does not believe that the Study's recommendations related to these other obligations are relevant here.

Although we are not proposing a fiduciary duty that includes a duty of care for broker-dealers, it is important to note that we believe that the proposed care obligation under Regulation Best Interest, in combination with existing broker-dealer obligations (such as best execution), is generally consistent with the underlying principles of—albeit more prescriptive than—the duty of care enforced under the Advisers Act. We believe any differences in the articulation of these standards for broker-dealers, as compared to investment advisers, is appropriate given differences in the structure and characteristics of their relationships with retail customers, to preserve and incorporate existing guidance and interpretations related to broker-dealer suitability obligations, and to provide clarity to how Regulation Best Interest would change existing obligations.

#### e. Request for Comment on Proposed Care Obligation

The Commission requests comment generally on the proposed care obligation. In addition, the Commission seeks comment on the following specific issues:

- Would the Care Obligation cause a broker-dealer to act in a manner that is consistent with what a retail customer would reasonably expect from someone who is required to act in their best interest? Why or why not?

- Under the Care Obligation, a broker-dealer must exercise reasonable diligence, care, skill, and prudence when making a recommendation, including assessing the potential risks and rewards associated with the recommendation. Do commenters believe that Regulation Best Interest is sufficiently clear that a broker-dealer and its associated natural persons may make a recommendation which may result in investor losses due to market or other risks inherent in investing?

- Has the Commission provided sufficient guidance on how a broker-dealer can satisfy each component of the Care Obligation?

- Do commenters believe the proposed Care Obligation enhances broker-dealers' existing suitability obligations?

- Are there aspects of a broker-dealer's existing suitability obligations that the Commission should not incorporate? Are there additional obligations that the Commission should incorporate? If so, which ones and why?

- As noted, the Commission is not proposing additional aspects of the duty of care that are specified in the 913 Study—notably best execution and fair pricing and compensation requirements, as broker-dealers are currently subject to explicit standards of conduct relating to best execution and fair and reasonable compensation. Do commenters agree that enhancements to these obligations are not required at this time? If not, please explain why.

- Is there sufficient clarity regarding how a broker-dealer “exercises reasonable diligence, care, skill, and prudence”? In addition, is “prudence” a sufficiently clear term when referring to the broker-dealer's Care Obligation? Should the Commission consider another formulation for this obligation? If so, what language would be clearer?

- Is there sufficient clarity regarding how a broker-dealer determines if it has a reasonable basis to believe that the recommendation is in the best interest of “some” retail customers in paragraph (a)(2)(ii)(A)? Why or why not? Should the rule expressly require a broker-dealer or associated person, in formulating this belief, to take into account all benefits to the broker-dealer or associated person from the recommendation and the costs to a hypothetical retail customer? Should the Commission require that a broker-dealer have a reasonable basis to believe that a recommendation is appropriate for the category of retail customers to which the retail customer belongs?

- Is there sufficient clarity regarding how a broker-dealer determines if it has a “reasonable basis to believe that that the recommendation is the best interest of the retail customer based on the retail customer's investment profile and the potential risks and rewards associated with the recommendation” in paragraph (a)(2)(i)(B)? Why or why not? Should the rule expressly require a broker-dealer or associated person, in formulating this belief, to take into account all benefits to the broker-dealer or associated person from the recommendation and the costs to the retail customer?

- Should the Commission take a different approach to defining the Care Obligation? If so, what approach should the Commission and take and why? For example, in lieu of establishing a Care

Obligation that requires recommendations in the “best interest,” as described, should the Care Obligation codify existing suitability obligations and require certain additional obligations (such as not placing the financial or other interest of the broker-dealer ahead of the retail customer)? If so, what additional obligations should be required and why?

- As noted above, the Commission preliminarily believes it is appropriate to incorporate the concept of a “customer's investment profile” consistent with FINRA's suitability rule. Do commenters agree? Why or why not? Should additional factors be considered?

- Should the Commission require broker-dealers to document their efforts to collect investment profile information? Relatedly, should broker-dealers be required to document why they believe one or more factors in a customer's investment profile are not relevant to a determination regarding whether a recommendation is in the best interest for a particular customer? Why or why not?

- Should the interpretation of what it means to make a recommendation in the “best interest” for purpose of paragraph (a)(2)(i)(B) be different from the interpretation of the best interest obligation under paragraph (a)(1)? Why or why not? Please be specific regarding any alternative suggestions and what they would or would not require. If the standard were different, should the Commission change the provision in the proposed rule that the obligation under paragraph (a)(1) is satisfied only by compliance with the elements of paragraph (a)(2)? If so, should the obligation in paragraph (a)(1) be an independent obligation, for violation of which a broker-dealer and associated person could be liable even if they complied with the elements of paragraph (a)(2)?

- Should a broker-dealer and its associated persons, when considering similar investment options available through the broker-dealer, have the obligation to recommend the least expensive and/or least remunerative option, at least if all other relevant factors are equal? Why or why not? What other factors should be relevant in such consideration?

- Should a broker-dealer and its associated persons, when considering investment options, only be required to consider options available through the broker-dealer? Alternatively, if a broker-dealer and its associated persons are required to consider additional options outside the broker-dealer, how should the Commission articulate the extent of this duty? Please be specific.

<sup>288</sup> See Fiduciary Duty Interpretive Release.

- Is the phrase “reasonably available alternative” sufficiently clear? Should the Commission specify certain factors to be used in the determination? Is there an alternative phrase or term that would be clearer? Please be specific.

- Is there sufficient clarity regarding what “less expensive” or “least remunerative” means and under what circumstances expense or remuneration should be a significant factor?

- Should the Commission define what “best interest” means for purposes of paragraph (a)(2)(i)(B)?

- Do commenters agree that turnover rate, cost-to-equity ratio and in-and-out-trading are relevant factors for determining that a series of recommended transactions is excessive for purposes of paragraph (a)(2)(i)(C)? If not, what factors should a broker-dealer consider with respect to this proposed obligation? Should the Commission expressly articulate the relevant factors as part of the rule?

- The Commission is proposing to use the term “series of recommended transactions” as part of the obligation in paragraph (a)(2)(i)(C), which is based, in part, on FINRA’s quantitative suitability obligation. Is “series of recommended transactions” a sufficiently clear term when referring to the quantity/frequency of trades? Should the Commission consider another formulation for this obligation? If so, what language would be clearer?

- As noted above, the best interest obligation would not extend beyond a particular recommendation or generally require a broker-dealer to have a continuing duty to a retail customer. Is there sufficient clarity regarding how the obligation applies to a series of recommended transactions? Why or why not?

- The Commission is proposing, as part of the obligation in paragraph (a)(2)(i)(C), that a broker-dealer must have a reasonable basis to believe that a series of recommended transactions is *not excessive* and is *in the retail customer’s best interest*. Should the Commission consider requiring only a reasonable basis to believe that a “series of recommended transactions” (or such other term per the preceding question) is *not excessive*, or in the alternative, only requiring a reasonable basis to believe that a series of recommended transactions (or such other term per the preceding question) is *in the retail customer’s best interest*? If so, why?

- As noted above, FINRA’s quantitative suitability rule requires a broker-dealer to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are

*not excessive and unsuitable* for the customer when taken together in light of the customer’s investment profile. The Commission’s proposed obligation, instead, would require a broker-dealer to have a reasonable basis to believe that a series of recommended transactions is not excessive and *is in the retail customer’s best interest*. Should the Commission consider different language, for example, requiring a reasonable basis to believe that a series of recommended transactions is not excessive *and not contrary* to the retail customer’s best interest? Why or why not?

- The Commission is not proposing to incorporate the element of control or *de facto* control in the requirement that a broker-dealer form a reasonable basis to believe that a series of recommended transactions, even if in the best interest of the retail customer 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. Should the Commission require “control” or “*de facto*” control? Why or why not?

### 3. Conflict of Interest Obligations

The Commission is proposing two requirements under Regulation Best Interest focused specifically on the treatment of conflicts of interest. These Conflict of Interest Obligations would require a broker-dealer entity<sup>289</sup> to: (1) Establish, maintain, and enforce written policies and procedures reasonably designed to identify, and disclose, or eliminate, all material conflicts of interest that are associated with recommendations covered by Regulation Best Interest; and (2) establish, maintain, and enforce written policies and procedures reasonably designed to identify, and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

We believe that requiring the establishment of such policies and

<sup>289</sup> Unlike the Disclosure and Care Obligations, which apply to a broker or dealer and to natural persons who are associated persons of a broker or dealer, the proposed Conflict of Interest Obligations apply solely to the broker or dealer entity, and not to the natural persons who are associated persons of a broker or dealer. For purposes of discussing the Conflict of Interest Obligations, the term “broker-dealer” refers only to the broker-dealer entity, and not to such individuals. While the Conflict of Interest Obligation applies only to the broker-dealer entity, the conflicts of interest that the broker-dealer entity must analyze are between: (i) The broker-dealer entity and the retail customer, (ii) the natural persons who are associated persons and the retail customer, and (iii) the broker-dealer entity and the natural persons who are associated persons (if the retail customer is indirectly impacted).

procedures is critical to identifying and addressing conflicts of interest, whether through elimination or, at a minimum, disclosure (and mitigation, in the case of financial incentives). We also believe that policies and procedures help ensure compliance with the proposed requirement to disclose any material conflicts of interest associated with a broker-dealer’s recommendations pursuant to the Disclosure Obligation described above. We further believe that requiring the establishment of such policies and procedures serves the Commission’s goal of facilitating the disclosure and mitigation of material conflicts of interest, while minimizing additional compliance costs that may be passed on to retail customers.

Under the proposed rule, broker-dealers would be permitted to exercise their judgment as to whether, for example, the conflict can be effectively disclosed (as discussed in Disclosure Obligation), determine what conflict mitigation methods may be appropriate, and determine whether or how to eliminate a conflict, if necessary, so long as the broker-dealer’s policies and procedures are reasonably designed. Whether a broker-dealer’s policies and procedures are reasonably designed to meet its Conflict of Interest Obligations will depend on the facts and circumstances of a given situation. The Commission also believes requiring policies and procedures specifically aimed at mitigating, in addition to disclosing, material conflicts of interest arising from financial incentives provides enhanced protections not available to retail customers through disclosure alone.

A broker-dealer would not comply with the Conflict of Interest Obligations of Regulation Best Interest by simply creating policies and procedures, if the broker-dealer does not maintain and enforce such policies and procedures.<sup>290</sup> Broker-dealers are already subject both to liability for failure to supervise under Section 15(b)(4)(E)<sup>291</sup> of the Exchange Act and to express supervision requirements under SRO rules, including the establishment of policies

<sup>290</sup> In the 913 Study, the staff stated that policies and procedures alone are not sufficient to discharge supervisory responsibility; it is also necessary to implement measures to monitor compliance with those policies and procedures. See 913 Study at 74, (citing *In re Application of Stuart K. Patrick*, Exchange Act Release No. 32314 (May 17, 1993); *In re Application of Richard F. Kresge*, Exchange Act Release No. 55988 (June 29, 2007) (demonstrating the Commission’s approach over the years)).

<sup>291</sup> See Section 15(b)(4)(E) of the Exchange Act (authorizing the Commission to impose sanctions on a firm or any associated person that fails reasonably to supervise another person subject to its supervision that commits a violation of the federal securities laws).

and procedures reasonably designed to prevent and detect violations of, and to achieve compliance with, the federal securities laws and regulations, as well as applicable SRO rules.<sup>292</sup> As such, we believe that a broker-dealer could comply with the policies and procedures requirement of Regulation Best Interest by adjusting its current systems of supervision and compliance, as opposed to creating new systems.

#### a. Material Conflicts of Interest and Material Conflicts of Interest Arising From Financial Incentives Associated With Such Recommendations

As noted in the discussion of the Disclosure Obligation in Section II.D.1., we propose to interpret, for purposes of Regulation Best Interest, a “material conflict of interest” as a conflict of interest that a reasonable person would expect might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested.<sup>293</sup>

For purposes of the Conflict of Interest Obligation in paragraph (a)(2)(iv), we preliminarily believe that material conflicts of interest arising from “financial incentives” associated with a recommendation generally would include, but are not limited to, compensation practices established by the broker-dealer, including fees and other charges for the services provided and products sold; employee compensation or employment incentives (*e.g.*, quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); compensation practices involving third-parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third-parties (*e.g.*, sub-accounting or administrative services provided to a mutual fund); receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third-party; sales of proprietary products or services, or products of affiliates; and transactions that would be effected by the broker-dealer (or an affiliate thereof) in a principal capacity.

While our interpretation of the types of material conflicts of interest arising from financial incentives is broad, we

<sup>292</sup> See FINRA Rule 3110 (Supervision) (requiring firms to establish and maintain systems to supervise the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules).

<sup>293</sup> See Section II.D.I.b.

do not intend to require broker-dealers to mitigate every material conflict of interest in order to satisfy their Conflict of Interest Obligations. We request comment below on the scope of the term financial incentives, whether we have appropriately identified the types of financial incentives that should be eliminated or mitigated and disclosed, whether there are other material conflicts of interest commenters believe are more appropriately eliminated or mitigated and disclosed, and whether there are certain financial incentives that are appropriately addressed through disclosure and for which additional mitigation is unnecessary or that the burden of mitigating the conflict would not justify any associated benefit to retail customers.

The Commission’s proposed Conflict of Interest Obligations are limited to material conflicts of interest, and to material conflicts arising from financial incentives, that are *associated with a recommendation*. The Commission believes this limitation is appropriate because broker-dealers often provide a range of services as part of any relationship with a retail customer, many of which would not involve a recommendation, and such services already are subject to general antifraud liability and specific requirements to address associated conflicts of interest.<sup>294</sup> We are not proposing to change the disclosure obligations associated with these services under the general antifraud provisions of the federal securities laws.

#### b. Reasonably Designed Policies and Procedures

In determining whether a broker-dealer “establishes, maintains, and enforces reasonably designed policies and procedures,” to address its material conflicts of interest, as required by the Conflict of Interest Obligations, the Commission preliminarily believes it would consider whether a broker-dealer has adequate compliance and supervisory policies and procedures in place (as well as a system for applying such procedures) to identify and at a minimum disclose (and mitigate, in the case of financial incentives) or eliminate, material conflicts of interest. We believe that there is no one-size-fits-all framework, and broker-dealers should have flexibility to tailor the policies and procedures to account for, among other things, business practices, size and complexity of the broker-dealer, range of services and products

<sup>294</sup> See *supra* notes 87, 175, 176, 177 and accompanying text.

offered and associated conflicts presented.

We believe that it would be reasonable for broker-dealers to use a risk-based compliance and supervisory system to promote compliance with Regulation Best Interest, rather than conducting a detailed review of each recommendation of a securities transaction or security-related investment strategy to a retail customer.<sup>295</sup> Use of a risk-based compliance and supervisory system would grant broker-dealers the flexibility to establish systems that are tailored to their business models, and to focus on specific areas of their business that pose the greatest risk of noncompliance with the Conflict of Interest Obligations,<sup>296</sup> as well as the greatest risk of potential harm to retail customers through such noncompliance. We believe that this would protect retail customers by focusing the broker-dealer’s resources on the areas of greatest risk to both the firm and the retail customer, as opposed to focusing on every aspect of the broker-dealer’s business, regardless of the level of risk of noncompliance or harm.

Among the components that broker-dealers should consider including in their programs are: Policies and procedures outlining how the firm identifies its material conflicts (and material conflicts arising from financial incentives), including such material conflicts of natural persons associated with the broker-dealer, clearly identifying all such material conflicts of interest and specifying how the broker-dealer intends to address each conflict; robust compliance review and monitoring systems; processes to escalate identified instances of

<sup>295</sup> We propose to interpret the term “risk-based” consistent with SRO rules so that broker-dealers can incorporate these new obligations into their current compliance infrastructure. According to FINRA, “the term ‘risk based’ describes the type of methodology a firm may use to identify and prioritize for review those areas that pose the greatest risk of potential securities law and self-regulatory organization (SRO) rule violations. In this regard, a firm is not required to conduct detailed reviews of each transaction if the firm is using a reasonably designed risk-based review system that provides the firm with sufficient information to enable the firm to focus on the areas that pose the greatest numbers of and risks of violation.” See FINRA Regulatory Notice 14–10, Consolidated Supervision Rules (Mar. 2014).

<sup>296</sup> As previously noted, the Commission would expect smaller investment advisers without conflicting business interests to require much simpler policies and procedures than larger firms that, for example, have multiple potential conflicts as a result of their other lines of business or their affiliations with other financial service firms. See, *e.g.*, Compliance Programs of Investment Companies and Investment Advisers Act Release No. 2204 (Dec. 17, 2003) (“Advisers Act Release 2204”).

noncompliance to appropriate personnel for remediation; procedures that clearly designate responsibility to business lines personnel for supervision of functions and persons;<sup>297</sup> including determination of compensation;<sup>298</sup> processes for escalating conflicts of interest; processes for a periodic review and testing of the adequacy and effectiveness of policies and procedures;<sup>299</sup> and training on the policies and procedures.<sup>300</sup>

### c. Identifying Material Conflicts of Interest

We believe that having a process to identify and appropriately categorize such conflicts of interest is a critical first step in helping to ensure that broker-dealers have reasonably designed policies and procedures to eliminate, or at a minimum disclose (and mitigate, as required) their material conflicts of interest. Reasonably designed policies and procedures to identify material conflicts of interest (including material conflicts arising from financial incentives) generally should do the following:

(i) Define such material conflicts in a manner that is relevant to a broker-dealer's business (*i.e.*, material conflicts of both the broker-dealer entity and natural persons who are associated persons of the broker-dealer), and in a way that enables employees to understand and identify conflicts of interest;

(ii) establish a structure for identifying the types of material conflicts that the broker-dealer (and natural persons who are associated persons of the broker-dealer) may face, and whether such conflicts arise from financial incentives;

(iii) establish a structure to identify conflicts in the broker-dealer's business as it evolves;

(iv) provide for an ongoing (*e.g.*, based on changes in the broker-dealer's business or organizational structure,

changes in compensation incentive structures, and introduction of new products<sup>301</sup> or services) and regular, periodic (*e.g.*, annual) review for the identification of conflicts associated with the broker-dealer's business; and

(v) establish training procedures regarding the broker-dealer's material conflicts of interest, including material conflicts of natural persons who are associated persons of the broker-dealer, how to identify such material conflicts of interest (and material conflicts arising from financial incentives), as well as defining employees' roles and responsibilities with respect to identifying such material conflicts of interest.

### d. Disclosure, or Elimination, of Material Conflicts of Interest and Disclosure and Mitigation, or Elimination, of Material Conflicts of Interest Arising From Financial Incentives Associated With a Recommendation

In addition to identifying material conflicts of interest, the Commission proposes to require that the policies and procedures be reasonably designed to at a minimum disclose, or eliminate, all material conflicts of interest associated with making recommendations to retail customers. In addition to the general guidance regarding reasonably designed policies and procedures outlined above, we believe that reasonably designed policies and procedures generally should establish a clearly defined and articulated structure for: Determining how to effectively address material conflicts of interest identified (*i.e.*, whether to eliminate or disclose (and mitigate, as required) the material conflict); and setting forth a process to help ensure that material conflicts are effectively addressed as required by the policies and procedures.

If a broker-dealer determines to satisfy its obligation to address material conflicts of interest through disclosure, the broker-dealer should consider the preliminary guidance on aspects of

effective disclosure, as discussed above in the Disclosure Obligation.<sup>302</sup>

While the Conflict of Interest Obligations would require a broker-dealer to have policies and procedures reasonably designed to at a minimum disclose or eliminate all material conflicts of interest related to the recommendation (or to disclose and mitigate or eliminate those material conflicts of interest arising from financial incentives), it does not mandate the absolute elimination of any particular conflicts, absent another requirement to do so. The absolute elimination of some particular conflicts could mean a broker-dealer may not receive compensation for its services, which is not the Commission's intent.

A broker-dealer seeking to address its Conflict of Interest Obligations through elimination of a material conflict of interest could choose to eliminate the conflict of interest entirely, for example, by removing incentives associated with a particular product or practice or not offering products with special incentives. Alternatively, a broker-dealer could satisfy this obligation by negating the effect of the conflict by, for example, in the case of conflicts related to affiliated mutual funds, crediting fund advisory fees against other broker-dealer charges—thus effectively eliminating the material conflict of interest.

Furthermore, although the Commission is not proposing to require a broker-dealer to develop policies and procedures to both disclose and mitigate *all* material conflicts of interest (outside of the material conflicts arising from financial incentives, which would specifically require mitigation), the proposed Conflict of Interest Obligations would require that a broker-dealer develop policies and procedures reasonably designed to “*at a minimum disclose, or eliminate*” all material conflicts. As such, a broker-dealer may determine to design its policies and procedures to address material conflicts of interest by both disclosing a conflict and taking other additional steps to mitigate the conflict (outside of the material conflicts arising from financial incentives, which would specifically require mitigation). However, in situations where the broker-dealer determines that disclosure does not reasonably address the conflict, for example, where the disclosure cannot be made in a simple or clear manner, or otherwise does not help the retail customer's understanding of the conflict or capacity for informed decision-making, or where the conflict is such

<sup>297</sup> See *Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act*, Division of Trading and Markets (Sept. 30, 2013), available at <https://www.sec.gov/divisions/marketregr/faq-cco-supervision-093013.htm> (providing guidance on the roles and duties of compliance and legal personnel at broker-dealers).

<sup>298</sup> The Commission believes that the ability to control the compensation of registered representatives is a key mechanism by which registered broker-dealers exercise supervisory controls.

<sup>299</sup> See Advisers Act Release 2204; see also *Staff Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs* (May 2006), available at [https://www.sec.gov/info/cco/adviser\\_compliance\\_questions.htm](https://www.sec.gov/info/cco/adviser_compliance_questions.htm).

<sup>300</sup> *Id.*

<sup>301</sup> FINRA Conflicts Report at 3 (“Firms at the forefront of financial innovation are in the best position, and are uniquely obligated, to identify the conflicts of interest that may exist at a product's inception or that develop over time. There are a number of effective practices firms can adopt to address such conflicts. First, firms can use a new product review process—typically through new product review committees—that includes a mandate to identify and mitigate conflicts that a product may present. Second, firms should disclose those conflicts in plain English, with the objective of helping ensure that customers comprehend the conflicts that a firm or registered representative have in recommending a product. These conflicts may be particularly acute where complex financial products are sold to less knowledgeable investors, including retail investors.”)

<sup>302</sup> See Section I.I.D.1.

that it may be difficult for the broker-dealer to determine that it is not putting its own interest ahead of the retail customer's interest, under the proposed obligation to have reasonably designed policies and procedures to "at a minimum disclose, or eliminate" all material conflicts the broker-dealer would need to establish policies and procedures reasonably designed to either eliminate the conflict or to both disclose and mitigate the conflict.

#### e. Mitigation of Material Conflicts of Interest Arising From Financial Incentives

Under the requirement relating to the treatment of conflicts of interest arising from financial incentives, the Commission proposes to require broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives. This proposed requirement is intended to capture the range of financial incentives that could pose a material conflict of interest.

The Commission recognizes the importance of the brokerage model as a potentially cost-effective (and sometimes, a less costly) option for investors to pay for investment advice. As discussed above, the Commission recognizes, however, that broker-dealer financial incentives—including internal compensation structures and compensation arrangements<sup>303</sup> with third parties—create inherent conflicts that may affect the impartiality of a recommendation.<sup>304</sup> These financial incentives can create conflicts of interest that may be difficult, if not impossible, to effectively manage through disclosure alone, or to eliminate.<sup>305</sup> At the same time, the

<sup>303</sup> Conflicts of interest may arise from compensation other than sales compensation. For example, in the case of mutual funds, compensation for account servicing, sub-transfer agency, sub-accounting, recordkeeping or other administrative services provides an incentive for a firm to offer the mutual funds from or for which the firm receives such compensation and not offer other funds or products from or for which it does not receive such compensation.

<sup>304</sup> See Tully Report. The Commission has historically expressed concerns about the financial incentives that commission-based compensation provides to broker-dealers. In order to address these concerns and preserve the broker-dealer model to promote investor choice, Regulation Best Interest imposes the additional requirement to mitigate conflicts related to financial incentives. See *supra* Section I.A.

<sup>305</sup> Several commenters in response to Chairman Clayton's Statement expressed similar concerns regarding the limits of disclosure to address broker-dealer conflicts, and supported requiring both disclosure and mitigation of conflicts. See, e.g., Economic Policy Institute Letter; PIABA Letter;

Commission, like other regulators,<sup>306</sup> recognizes that differential compensation may appropriately recognize the time and expertise necessary to understand an investment, and in doing so promote investor choice and access to a range of products, and so elimination of the conflict may not be appropriate or desirable.<sup>307</sup>

In addition, through the proposed requirement to develop policies and procedures reasonably designed to mitigate conflicts of interest arising from financial incentives, we are clarifying how the best interest obligation would be fulfilled when a broker-dealer is engaging in principal trading by requiring a broker-dealer to, through its required policies and procedures, identify and address, the financial incentives presented by principal trading.<sup>308</sup>

Financial Planning Coalition Letter ("The Coalition believes that disclosures alone are insufficient to remedy investor confusion and harm stemming from conflicted advice. Although the Coalition agrees that disclosures can be a useful and important tool for investors, relying solely on disclosures is inconsistent with the SEC's mission of investor protection and contradicts substantial prior research demonstrating that disclosures alone are ineffective. The Coalition opposes a disclosure-only regime and urges consideration of system based on either conflict avoidance or disclosures coupled with proper mitigation."); Nationwide Letter ("... Nationwide is firmly committed to supporting a new best interest standard of care for broker-dealers that focuses on increased transparency and mitigation of conflicts, while at the same time protecting consumers' access to advice, choice, and affordable products."); LPL Financial Letter (recommending that the Commission consider adopting a standard of conduct that preserves financial institutions' flexibility to avoid or manage conflicts in which they have a competing financial interest, provided they fully and fairly disclose the nature of such conflicts to investors and take such additional steps as may be necessary to ensure such conflicts do not adversely affect the impartiality and prudence of the advice they provide to investors).

<sup>306</sup> For example, the preamble to the BIC Exemption states "The Department has not made the requirements more stringent, as suggested by some commenters, so as to require completely level compensation. Different payments for different classes of investments may be appropriate based on differences in the time and expertise necessary to recommend them" and that under the BIC Exemption "differential compensation is permitted but only if the Financial Institution's policies and procedures, as a whole are reasonably designed to avoid a misalignment of interests between Advisers and Retirement Investors" and that "the payment of differential compensation should be based only on neutral factors." BIC Exemption Release, FR 21007, 21035–40.

<sup>307</sup> See, e.g., Letter from James D. Gallagher, Executive Vice President and General Counsel, John Hancock Life Insurance Company (U.S.A.) (Aug. 25, 2017) ("John Hancock Letter") ("Customer choice should allow advisers and broker-dealers to direct clients to products that suit their needs, whether or not those products are proprietary.');

<sup>308</sup> This is in line with the 913 Study recommendation that the Commission address how the uniform fiduciary standard of conduct would be fulfilled when engaging in principal trading, which

Accordingly, to make sure that recommendations are in the best interest of the retail customer, the Commission proposes requiring broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to identify and disclose and mitigate material conflict of interests related to financial incentives, in addition to the proposed requirement to establish, maintain and enforce written policies and procedures reasonably designed to identify and disclose or eliminate general material conflicts of interest in paragraph (a)(2)(iii).

As noted above, in lieu of mandating specific mitigation measures or a "one-size fits all" approach, the Commission's proposal would leave broker-dealers with flexibility to develop and tailor reasonably designed policies and procedures that include conflict mitigation measures, based on each firm's circumstances.<sup>309</sup> This principles-based approach provides broker-dealers the flexibility to establish their supervisory system in a manner that reflects their business models, and based on those models, focus on areas where heightened concern may be warranted.<sup>310</sup> The Commission believes that reasonably designed policies and procedures should include mitigation measures that depend on a variety of factors related to a broker-dealer's business model (such as the size of the broker-dealer, retail customer base, the nature and significance of the compensation conflict, and the complexity of the product), some of which may be weighed more heavily than others.<sup>311</sup> Depending on a broker-dealer's assessment of these factors as a whole, more or less demanding mitigation measures included in reasonably designed policies and procedures may be appropriate. For example, heightened mitigation measures, including enhanced supervision, may be appropriate in situations where the retail customer displays a less sophisticated understanding of securities investing

at a minimum should require disclosure but not necessarily require the specific procedures of Advisers Act Section 206(3). See Study at 113.

<sup>309</sup> FINRA observed that the appropriate framework for developing a conflicts governance framework depends on the scope and scale of a firm's business. See FINRA Conflicts Report. See also Letter from David T. Bellaire, Esq., Executive Vice President and General Counsel, Financial Services Institute (Oct. 30, 2017) ("FSI Letter") (recommending the Commission adopt a principles-based approach to allow firms to tailor their policies and procedures designed to identify, manage and mitigate conflicts to their unique business models).

<sup>310</sup> See FINRA Rule 3110(b)(1) (Supervision) and Section 15(b)(4)(E) of the Exchange Act.

<sup>311</sup> See FINRA Conflicts Report.

generally<sup>312</sup> or the conflicts associated with particular products involved,<sup>313</sup> where the compensation is less transparent (for example, a payment received from a third-party or built into the price of the product or a transaction versus a straight commission payment), or depending on the complexity of the product.<sup>314</sup> A broker-dealer could reasonably determine through its policies and procedures that the same mitigation measures could apply to a particular type of retail customer, type of product or type of compensation conflict across the board; or in some instances a broker-dealer may reasonably determine that some compensation conflicts may be more difficult to mitigate, and are more appropriately avoided in their entirety or for certain categories of retail customers. Policies and procedures may be reasonably designed at the outset, but

<sup>312</sup> We believe that broker-dealers would ordinarily obtain, pursuant to the proposed Care Obligation, sufficient facts concerning a retail customer to determine a retail investor's understanding of securities investing. As part of evaluating a recommendation and whether it is in a retail customer's best interest, the Care Obligation requires a broker-dealer to make a reasonable effort to ascertain information regarding an existing customer's investment profile, including, the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation. See paragraph (c)(2) of Proposed Regulation Best Interest (defining "Retail Customer Investment Profile").

<sup>313</sup> Currently, FINRA's heightened suitability requirements for options trading accounts require that a registered representative have "a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the complex product." FINRA Rule 2360(b)(19). FINRA has encouraged member firms to take a similar approach in recommending complex products. FINRA has noted that certain heightened procedures firms have taken include making approval of complex products contingent upon specific limitations or conditions, and prohibiting their sales force from recommending the purchase of some complex products to certain retail investors. See FINRA Regulatory Notice 12-03, Heightened Supervision of Complex Products (Jan. 2012).

<sup>314</sup> In a recent FINRA examination report, FINRA noted that the concerns that FINRA had during the course of examinations with regard to the suitability of certain products and their supervision did not vary materially by firm size, but did occur more frequently in connection with certain product classes, specifically unit investment trusts ("UITs") and certain multi-share class and complex products, such as leveraged and inverse exchange-traded funds ("ETFs"). See Report on FINRA Examination Findings (Dec. 2017), available at <http://www.finra.org/industry/2017-report-exam-findings> ("FINRA Exam Report 2017").

may later become unreasonable based on subsequent events or information obtained, such that the actual experience of a broker-dealer should be used to revise the broker-dealer's measures as appropriate. Further, what are considered reasonable mitigation measures for a small firm may be different than that for a large firm.<sup>315</sup> While many broker-dealers may have programs currently in place to manage conflicts of interest, each broker-dealer will need to carefully consider whether its existing framework complies with the proposed obligations under Regulation Best Interest.

For example, broker-dealers generally should consider incorporating the following non-exhaustive list of potential practices<sup>316</sup> as relevant into their policies and procedures to promote compliance with (a)(2)(iv) of proposed Regulation Best Interest<sup>317</sup>:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- minimizing compensation incentives for employees to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis—for example, establishing differential compensation criteria based on neutral factors (e.g., the time and complexity of the work involved);
- eliminating compensation incentives within comparable product lines (e.g., one mutual fund over a comparable fund) by, for example, capping the credit that a registered representative may receive across

<sup>315</sup> Large firms may address conflicts of interest through enterprise management or operational risk frameworks, and components of such programs, for example, risk and control self-assessments, may provide an opportunity to identify and evaluate possible impacts. By contrast, small firms selling basic products may have a conflicts management framework that relies largely on the tone set by the firm owner coupled with required supervisory controls, particularly related to suitability, and the firm's compensation structure. See FINRA Conflicts Report. An effective practice FINRA observed at a number of firms is implementation of a comprehensive framework to identify and manage conflicts of interest across and within firms' business lines that is scaled to the size and complexity of their business. See FINRA Conflicts Report at 5.

<sup>316</sup> See FINRA Conflicts Report at 26.

<sup>317</sup> As noted above, while the Commission believes these practices, if incorporated into written policies and procedures, may reasonably mitigate conflicts of interest arising from financial incentives, whether a recommended securities transaction or investment strategy complies with proposed Regulation Best Interest will turn on the facts and circumstances of the particular recommendation and the particular retail customer, and whether the broker-dealer has complied with the Disclosure Obligation and the Care Obligation.

comparable mutual funds or other comparable products across providers;

- implementing supervisory procedures to monitor recommendations that are: Near compensation thresholds; near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or, involve the rollover or transfer of assets from one type of account to another (such as recommendations to rollover or transfer assets in an ERISA account to an IRA, when the recommendation involves a securities transaction)<sup>318</sup> or from one product class to another<sup>319</sup>;
- adjusting compensation for registered representatives who fail to adequately manage conflicts of interest; and
- limiting the types of retail customers to whom a product, transaction or strategy may be recommended (e.g., certain products with conflicts of interest associated with complex compensation structures).

In addition, we believe certain material conflicts of interest arising from financial incentives may be more difficult to mitigate,<sup>320</sup> and may be more appropriately avoided in their entirety for retail customers or for certain categories of retail customers (e.g., less sophisticated retail customers). These practices may include the payment or receipt of certain non-cash compensation that presents conflicts of interest for broker-dealers, for example, sales contests, trips, prizes, and other similar bonuses that are based on sales of certain securities or accumulation of

<sup>318</sup> *Id.*

<sup>319</sup> See FINRA Exam Report 2017. FINRA observed a variety of effective practices in recommending the purchase and sale of certain products, including tailoring supervisory systems to products' features and sources of risk to customers. With respect to UITs, FINRA observed firms that alerted customers to the consequences of selling and reinvesting in a new UIT prior to the initial UIT's maturity using negative or positive consent letters. Some firms implemented surveillance patterns to identify early UIT rollovers under a variety of scenarios. In addition, some firms required registered representatives to enter a rationale into firm systems for each short-term UIT transaction and coupled the entry with documented supervisory review.

<sup>320</sup> See Tully Report. The Tully Report found the payment of up-front bonuses and accelerated payouts raised concerns not about particular recommendations but about the registered representative-client relationship because registered representatives are incentivized to generate large commissions through churning accounts or switching firms. The Tully Report suggested best practices to encourage long-term relationships through methods including, but not limited to, possible elimination of up-front bonuses or payment of up-front bonuses in the form of forgivable loans over a period of time.



assets under management.<sup>321</sup> Broker-dealers that make recommendations to retail customers that may involve such compensation practices should carefully assess the broker-dealer's ability to mitigate these financial incentives and whether they can satisfy their best interest obligation.

#### f. Consistency With Other Approaches

The Commission believes that the proposed requirements relating to the treatment of conflicts are designed to address, albeit in a less prescriptive manner, the same concerns regarding broker-dealer conflicts of interest as expressed by the DOL in adopting the DOL Fiduciary Rule and related PTEs, including the conflicts associated with financial incentives, underlying the BIC Exemption. Among other things, the BIC Exemption includes provisions requiring: (1) Disclosure of information on the firm's material conflicts of interest, including web and transaction-based disclosure; and (2) adoption of policies and procedures reasonably designed to: (i) Ensure that advisers (*i.e.*, individual representatives) adhere to the Impartial Conduct Standards (*e.g.*, provide best interest advice); (ii) prevent material conflicts of interest from causing violations of the Impartial Conduct Standards, and (iii) prevent the use of compensation or other incentives (*e.g.*, quotas, appraisals, bonuses, contests, special awards, differential compensation or other actions or incentives) that are intended or would reasonably be expected to cause advisers to make recommendations that

are not in the best interest of the retirement investor.<sup>322</sup>

The DOL has stated that the restriction on compensation incentives under the conditions of the BIC Exemption does not prevent the provision of differential compensation to individuals (whether in type or amount, and including, but not limited to, commissions) based on investment decisions to the extent that the policies and procedures and incentive practices, when viewed as a whole, are reasonably and prudently designed to avoid a misalignment of the interests of advisers with the investors they serve as fiduciaries.<sup>323</sup> However, the differential payments must be based on neutral factors, such as the time or complexity and the work involved (and not based on what is more lucrative to the firm), and the DOL noted the importance of employing supervisory oversight structures.<sup>324</sup> As an example, the DOL described a commission-based compensation schedule for representatives in which all variation in commissions is eliminated for recommendations of investments within reasonably designed categories, and the entity establishes supervisory mechanisms to protect against conflicts of interest created by the transaction-based model and takes special care to ensure that any differentials that are retained are based on neutral factors (*e.g.*, time or complexity) and do not incentivize based on the amount of compensation the entity would receive.<sup>325</sup>

Our proposed Conflict of Interest Obligations are designed to address these same concerns, and support the objective that the recommendations of broker-dealers will not be self-interested, with a principles-based approach that is designed to provide flexibility to broker-dealers as to how to disclose and mitigate such conflicts of interest, depending on their business model, the level of conflicts presented, and the retail customers they serve. While the Commission recognizes that broker-dealers are subject to supervisory

obligations under Section 15(b)(4)(E)<sup>326</sup> of the Exchange Act and detailed SRO rules, including the establishment of policies and procedures reasonably designed to prevent and detect violations of, and to achieve compliance with, the federal securities laws and regulations, as well as applicable SRO rules,<sup>327</sup> for the reasons set forth above, the Commission believes that broker-dealers should be expressly required to establish, maintain, and enforce written policies and procedures to identify and address (through elimination or disclosure, and mitigation in the case of financial incentives) material conflicts of interest.

Furthermore, our proposed rule subjects broker-dealers to additional requirements when certain material conflicts are present. Specifically, Regulation Best Interest requires written policies and procedures reasonably designed to identify and address, through disclosure or elimination, of any material conflicts of interest that are associated with the recommendation, and imposes heightened obligations requiring written policies and procedures reasonably designed to identify and address, through disclosure and mitigation, or elimination, of material conflicts of interest that are related to financial incentives. We believe that these requirements address the same concerns that the DOL sought to address regarding conflicts of interest and the duty of loyalty that underlies the detailed obligations of the BIC Exemption, and also help ensure investment recommendations will be in the retail customer's best interest, consistent with our understanding of the DOL's objectives in the BIC exemption.

We also believe that the proposed Conflict of Interest Obligations, in conjunction with our Disclosure Obligation, are consistent with the principles underlying the recommendations of the 913 Study relating to a duty of loyalty. In the uniform fiduciary standard recommended in the Study, "incorporating Advisers Act Section 206(1) and 206(2)" would require an investment adviser or broker-dealer to "eliminate, or provide full and fair

<sup>321</sup> For example, FINRA rules establish restrictions on the use of non-cash compensation in connection with the sale and distribution of mutual funds, variable annuities, direct participation program securities, public offerings of debt and equity securities, and real estate investment trust programs. These rules generally limit the manner in which members can pay for or accept non-cash compensation and detail the types of non-cash compensation that are permissible. See FINRA Rules 2310, 2320, 2331, and 5110. FINRA conducted a retrospective review of the gifts and gratuities and non-cash compensation rules to assess their effectiveness and efficiency. See FINRA Regulatory Notice 14-15, FINRA Requests Comment on the Effectiveness and Efficiency of its Gifts and Gratuities and Non-Cash Compensation Rules (Apr. 2014); FINRA Retrospective Rule Report, Gifts, Gratuities and Non-Cash Compensation (Dec. 2014). In response, SIFMA commented that it supported "restricting the use of sales targets and requiring that eligibility for training events be determined on the basis of total production, not the sale of specific securities" and recommended that "FINRA also consider whether these rules should be applied consistently to all securities products, rather than (as today) just to investment company securities, variable products and public offerings of securities." See Letter from Kevin A. Zambrowicz, Associate General Counsel & Managing Director, SIFMA (May 23, 2014).

<sup>322</sup> See BIC Exemption Release.

<sup>323</sup> See BIC Exemption Release at 21033-34. See also U.S. Department of Labor, Employee Benefits Security Administration, Conflict of Interest FAQs, Part I-Exemptions (Oct. 2017), available at <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-1.pdf> ("DOL FAQs Part I").

<sup>324</sup> See BIC Exemption Release at 21035-40. For example, the DOL notes that the touchstone is to always avoid structures that misalign the financial interests of the adviser with the interests of the retirement investor. See DOL FAQs Part I.

<sup>325</sup> See BIC Exemption Release 21038-39. See also DOL FAQs at 7-8.

<sup>326</sup> See Section 15(b)(4)(E) of the Exchange Act (authorizing the Commission to impose sanctions on a firm or any associated person that fails reasonably to supervise another person subject to their supervision that commits a violation of the federal securities laws).

<sup>327</sup> See FINRA Rule 3110 (Supervision) (requiring firms to establish and maintain systems to supervise the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules).

disclosure about its material conflicts of interest.”<sup>328</sup> In addition, the Study recommended that the Commission consider whether rulemaking “would be appropriate to prohibit certain conflicts, to require firms to mitigate conflicts through specific action, or to impose specific disclosure and consent requirements.”<sup>329</sup> Further, with respect to principal trading, the Study provided that the Commission should address how broker-dealers should fulfill the uniform fiduciary standard when engaging in principal trading.<sup>330</sup> The Study noted that under the standard a broker-dealer should be required at a minimum, to disclose its conflicts of interest related to principal transactions, including its capacity as principal, but it would not necessarily be required to follow the specific notice and consent procedures of Advisers Act Section 206(3).<sup>331</sup>

We believe that the proposed Conflict of Interest Obligations reflect and build upon the principles underlying these 913 Study recommendations. As recommended by the 913 Study, we are proposing to require, through implementation of policies and procedures, broker-dealers to, at a minimum disclose, or eliminate, all material conflicts of interest, which draws from principles of an investment adviser’s duty of loyalty under the Advisers Act, which includes an investment adviser’s duty to disclose. One difference between the Conflict of Interest Obligations under Regulation Best Interest and the principles in the 913 Study is that the proposed obligation for broker-dealers is limited to disclosure of material conflicts associated with a recommendation. As discussed above, the Commission believes this limitation is appropriate because broker-dealers often provide a range of services as part of any retail customer relationship, many of which would not involve a recommendation, and such services already are subject to general and specific requirements to address associated conflicts of interest.<sup>332</sup> As such, we are not proposing to change or to have any impact on the disclosure obligations associated with these services under the general antifraud provisions of the federal securities laws rather than this more specific obligation.

Further, in line with the 913 Study recommendations as discussed above, the Commission considered and

believes that it is appropriate to also propose a requirement to establish and maintain reasonably designed policies and procedures to disclose and mitigate, or eliminate, material conflicts of interest related to financial incentives, in light of the concerns regarding potential harm to retail customers resulting particularly from broker-dealer conflicts of interest associated with financial incentives, such as compensation practices.<sup>333</sup>

The proposed Conflict of Interest Obligations differ from the 913 Study in that Regulation Best Interest, as proposed, expressly requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to identify and address material conflicts, through elimination or disclosure (and mitigation in the case of material conflicts of interest arising from financial incentives), as opposed to expressly requiring that broker-dealers eliminate or provide full disclosure of conflicts of interest.<sup>334</sup> As discussed above, the Disclosure Obligation separately requires that broker-dealers disclose material conflicts of interest associated with the recommendation prior to or at the time of a recommendation. For the reasons set forth above, we believe that requiring broker-dealers to develop reasonably designed policies and procedures to identify and eliminate or disclose (and mitigate, as appropriate or required) material conflicts of interest is critical to compliance with management of conflicts of interest, and provides more flexibility to broker-dealers, and better serves the Commission’s goal of facilitating the elimination or disclosure and mitigation (as appropriate or required) of material conflicts of interest, and minimizing additional compliance costs that may be passed on to retail customers.

#### g. Request for Comment on the Conflict of Interest Obligations

The Commission generally requests comment on the best interest obligation relating to the treatment of conflicts of interest. Specifically, we request comment on the following issues:

- Would the Conflict of Interest Obligations cause a broker-dealer to act in a manner that is consistent with what a retail customer would reasonably expect from someone who is required to act in their best interest? Why or why not?

- Should the Conflict of Interest Obligations apply to natural persons

who are associated persons of a broker or dealer? Why or why not?

- Are there any specific interactions or relationships between the disclosure requirements under the Conflict of Interest Obligations and the Relationship Summary that should be addressed? Are there any specific interactions or relationships between the disclosure requirements under the Conflict of Interest Obligations and the Disclosure Obligation that should be addressed? If so, please explain.

- Are there any specific interactions or relationships between the disclosure requirements in Regulation Best Interest and the existing general antifraud provisions that should be addressed? If so, please explain.

- Do commenters believe the general antifraud provisions adequately address other non-recommendation related conflicts or should Regulation Best Interest also cover such conflicts?

- Do commenters agree with the requirement to create policies and procedures to promote and demonstrate compliance with the Conflict of Interest Obligations? Why or why not? If so, how should those policies and procedures differ, if at all, from those currently required by FINRA? If not, what other approaches do commenters suggest?

- Instead of requiring policies and procedures, should the Commission simply require broker-dealers to eliminate or mitigate and disclose conflicts of interest?

- Should the Conflict of Interest Obligations apply to natural persons who are associated persons? Why or why not?

- Do commenters agree with the Commission’s approach to provide flexibility to broker-dealers in meeting their Conflict of Interest Obligations? Why or why not?

- Is the guidance concerning policies and procedures clear? Would this guidance assist broker-dealers in understanding how they can demonstrate compliance with the Conflict of Interest Obligation? Is there additional guidance that would provide additional clarity?

- Do commenters have additional examples of processes or systems the Commission should suggest or require broker-dealers to include in compliance and supervisory programs?

- Should the Conflict of Interest Obligations specify certain minimum policies and procedures? If so, what specific required policies and procedures should we include?

- Should the Commission require in Regulation Best Interest that broker-dealers undergo supervisory and compliance reviews? If so, how

<sup>328</sup> 913 Study at 112–13.

<sup>329</sup> See *id.* at 118.

<sup>330</sup> See *id.* at 118–20.

<sup>331</sup> *Id.*

<sup>332</sup> See Section I.D.1.b.

<sup>333</sup> See *supra* Section I.A. See also Tully Report.

<sup>334</sup> See 913 Study at 112–13.

frequently and what would be the proper scope?

- Is it sufficiently clear to commenters that the Commission does not require the policies and procedures required by the Conflict of Interest Obligations be assessed on a transaction-by-transaction basis, but rather that broker-dealers may use a risk-based compliance and supervisory system? Why or why not?

- Should the Commission provide additional guidance on identification of material conflicts of interest? Why or why not? If so, what type of guidance should the Commission provide?

- Similar to the Care Obligation, should a broker-dealer be required to “exercise reasonable diligence, care, skill, and prudence” to comply with the Conflict of Interest Obligations? Why or why not? Would this lower or raise the standard for the Conflict of Interest Obligations?

- How will the Conflict of Interest Obligations affect dual-registrants? Do commenters believe dual-registrants can adequately comply with such requirements? Why or why not?

- Are the situations identified in this proposal those where conflicts of interest are present, the most prevalent or have the greatest potential for harm or both? To what extent are retail customers harmed by these types of conflicts?<sup>335</sup> For example, do certain types of conflicts and/or recommendations result in systematically lower net returns or greater degrees of risk in retail customers’ portfolios relative to other similarly situated investors in different relationships (e.g., investment adviser, bank and trust company, insurance company accounts)? Are there steps the Commission should take to identify and address these conflicts? Can they be appropriately addressed through disclosure or other means? How would any such steps to address potential conflicts of interest benefit retail customers currently and over time? What costs or other consequences, if any, would retail customers experience as a result of any such steps? For example, would broker-dealers be expected to withdraw from or limit their offerings or services in certain markets or certain products?

- Has the Commission identified the types of conflicts of interest that need to be addressed in connection with

Regulation Best Interest and are these appropriately addressed to meet the objective that broker-dealers provide recommendations in the best interest of retail customers? Are there new or different types of conflicts of interest that the Commission should consider? If so, which ones?

- Do commenters have other suggestions on how broker-dealers can eliminate material conflicts of interest, including financial incentives? If so, please provide examples.

- Do commenters agree with the scope of the Commission’s proposed requirement related to disclosure and mitigation, or elimination, of all material conflicts of interest arising from financial incentives? Do commenters agree with the proposed interpretation of such financial incentives? Why or why not? Please explain. Do commenters believe any financial incentives could be adequately addressed through disclosure or elimination (and do not require mitigation)? If so, which ones? Why or why not? Which material conflicts of interest do commenters believe must be mitigated? Why?

- Do commenters believe that retail customers recognize and understand material conflicts of interest presented by broker-dealer compensation arrangements, including the incentive to seek to increase broker-dealers’ compensation at the expense of the retail customers they are advising?

- In lieu of or in addition to disclosure, should the Commission explicitly require firms to mitigate conflicts generally and not only those arising from financial incentives? Why or why not? Or should we provide flexibility to firms to decide whether to disclose or mitigate conflicts generally (e.g., to provide flexibility to firms on how to address conflicts of interest)? Or are there certain conflicts beyond financial incentives, that should be both disclosed and mitigated (or eliminated)?

- Are there circumstances in which the Commission should explicitly require elimination of certain material conflicts of interest because mitigation would not be sufficient? Why or why not? If so, please specify which ones.

- Should Regulation Best Interest expressly require broker-dealers to regularly (e.g., at least annually) and rigorously review their written policies and procedures to make sure that they have supervisory and compliance systems to identify and address all of their material conflicts of interest?

- Commenters in the past have highlighted several activities of broker-dealers that are most likely to be impacted by an enhanced standard of

care for the provision of investment advice to retail customers, such as a fiduciary standard. The Commission requests data and other information related to the nature and magnitude of conflicts of interest when broker-dealers engage in these activities and how Regulation Best Interest would serve to increase or decrease broker-dealers’ conflicts of interest:

- Recommending proprietary products and products of affiliates;
- Engaging in principal trades with respect to a recommended security (e.g., fixed income products);
- Recommending a limited range of products and/or services;
- Recommending a security underwritten by the firm or a broker-dealer affiliate, including initial public offerings;
- Allocating investment opportunities among retail customers (e.g., IPO allocation);
- Receiving third-party compensation in connection with securities transactions or distributions (e.g., sales loads, ongoing asset-based fees, or revenue sharing); and
- Providing ongoing, episodic or one-time advice.

The Commission also requests comment on reasonable conflict mitigation measures, specifically:

- What factors should broker-dealers weigh and evaluate in establishing reasonable mitigation measures?
- Should the Commission take a more prescriptive approach with regard to conflict mitigation measures? Why or why not?
- Do commenters have further examples of potential mitigation measures beyond the non-exhaustive list provided above? Do commenters believe that any of the examples provided on the list would not be effective at mitigating conflicts related to financial incentives? Why or why not?
- What impact should the firm’s size have on implementation of reasonable mitigation measures?
- Are there conflicts of interest that commenters believe the Commission should prohibit? If so, which ones and why? For example, do commenters believe the Commission should prohibit receipt of certain non-cash compensation (e.g., sales contests, trips, prizes, and other bonuses based on sales of certain securities, accumulation of assets under management or any other factor)? Why or why not?
- Should the Commission require affirmative retail customer consent for certain types of conflicts of interest? Why or why not?

<sup>335</sup> See Definition of the Term “Fiduciary;” Conflict of Interest Rule—Retirement Investment Advice, 81 FR 20945 (Apr. 8, 2016) (to be codified at 29 CFR pts. 2509, 2510 and 2550) (stating that conflicts of interest with respect to transactions pose “special dangers to the security of retirement, health, and other benefit plans”).

• Would the guidance related to mitigating conflicts provide clarity to firms? Why or why not? Is this guidance consistent with the Commission's goal of improving the quality of recommendations that retail customers receive? What are some areas in which commenters would like more guidance?

• Are there certain product classes that commenters believe the Commission should outright prohibit? If so, which ones and why?

• Do commenters believe neutral compensation across certain products (e.g., equities, mutual funds, variable annuities, ETFs) is an appropriate mitigation measure? Why or why not?

#### E. Recordkeeping and Retention

In connection with proposed Regulation Best Interest, we are proposing new record-making and recordkeeping requirements for broker-dealers with respect to certain information collected from or provided to retail customers. Exchange Act Section 17(a)(1) requires registered broker-dealers to make and keep for prescribed periods such records as the Commission deems "necessary or appropriate in the public interest, for the protection of investors."<sup>336</sup> Exchange Act Rules 17a-3 and 17a-4 specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents must be kept, respectively.

Under Rule 17a-3(a)(17), broker-dealers that make recommendations for accounts with a natural person as customer or owner are required to create and periodically update customer account information.<sup>337</sup> As part of developing a "retail customer's investment profile," proposed Regulation Best Interest may require broker-dealers to seek to obtain certain retail customer information that is currently not required pursuant to Rule 17a-3(a)(17). In addition, proposed Regulation Best Interest would require broker-dealers to reasonably disclose in writing the material facts relating to the scope and terms of their relationship with the retail customer and all material conflicts of interest that are associated with the investment recommendations provided to the retail customer.

Accordingly, we are proposing to amend Rule 17a-3 to add a new paragraph (a)(25), which would 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 Regulation Best Interest, as well as the identity of each natural person who is an associated person of a broker or dealer, if any, responsible for the account. The new paragraph would specify, however, that the neglect, refusal, or inability of a retail customer to provide or update any such information would excuse the broker-dealer from obtaining that information.<sup>338</sup>

Under Rule 17a-4(e)(5), broker-dealers are required to maintain and preserve in an easily accessible place all account information required pursuant to Rule 17a-3(a)(17)<sup>339</sup> for six years.<sup>340</sup> We are proposing to amend Exchange Act Rule 17a-4(e)(5) to require broker-dealers to retain any information that the retail customer provides to the broker-dealer or the broker-dealer provides to the retail customer pursuant to Rule 17a-3(a)(25), in addition to the existing requirement to retain information obtained pursuant to Rule 17a-3(a)(17). As a result, broker-dealers would be required to retain all of the information collected from or provided to each retail customer pursuant to Regulation Best Interest for six years.

We are not proposing new record retention requirements regarding the written policies and procedures that broker-dealers would be required to create pursuant to Regulation Best

<sup>338</sup> Rule 17a-3(a)(17) applies to each account with a natural person as a customer or owner, while proposed Regulation Best Interest would apply to each recommendation of any securities transaction or investment strategy involving securities to a retail customer. Because of this difference, the Commission believes it would be appropriate to locate the record-making requirements related to Regulation Best Interest in a new paragraph of Rule 17a-3 rather than in an amendment to paragraph (a)(17).

<sup>339</sup> Under Rule 17a-3(a)(17), broker-dealers that make recommendations for accounts with a natural person as customer or owner are required to create, and periodically update, customer account information. As part of developing a "retail customer's investment profile," proposed Regulation Best Interest would require broker-dealers to seek to obtain certain retail customer information that is currently not required to be created under Rule 17a-3(a)(17). Because broker-dealers are already required to seek to obtain identical information pursuant to the FINRA suitability rule, we believe that broker-dealers should already be attempting to collect, pursuant to the FINRA suitability rule, or collecting under existing Exchange Act books and records rules, the information that would be required pursuant to Regulation Best Interest. Accordingly, we do not believe that it is necessary to impose any new record-making requirement upon broker-dealers.

<sup>340</sup> See Exchange Act Rule 17a-4(e)(5) (account record information required pursuant to Rule 17a-3(a)(17) must be maintained and preserved in an easily accessible place until at least six years after the earlier of the date the account was closed, or the date on which the information was replaced or updated).

Interest because such information is already currently required to be retained pursuant to Exchange Act Rule 17a-4(e)(7).<sup>341</sup> Rule 17a-4(e)(7) requires broker-dealers to retain compliance, supervisory, and procedures manuals (and any updates, modifications, and revisions thereto) describing the policies and practices of the broker-dealer with respect to compliance with applicable laws and rules, and supervision of the activities of each natural person associated with the broker-dealer, for a specified period of time.

The Commission requests comment on recordkeeping and retention requirements related to Regulation Best Interest:

• Should the Commission impose additional record-making requirements related to Regulation Best Interest? Why or why not? If the Commission were to adopt additional requirements, what records should we specifically require broker-dealers to make?

• Should the Commission impose additional record retention requirements related to Regulation Best Interest? Why or why not? If the Commission were to adopt additional requirements, what records should we specifically require broker-dealers to retain?

#### F. Whether the Exercise of Investment Discretion Should Be Viewed as Solely Incidental to the Business of a Broker or Dealer

The Advisers Act regulates the activities of certain "investment advisers," who are defined in section 202(a)(11) of the Advisers Act as persons who, for compensation, engage in the business of advising others about securities. Section 202(a)(11)(C) excludes from the definition of investment adviser a broker or dealer whose performance of such advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation for those services (the "broker-dealer exclusion"). The broker-dealer exclusion shows, on the one hand, that Congress recognized broker-dealers may give a certain amount of advice to their customers in the course of their regular business as broker-dealers and that it would be inappropriate to bring them within the scope of the Advisers Act merely because of this aspect of their

<sup>341</sup> FINRA Rule 3110 requires written supervisory procedures that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. See FINRA Rule 3110(b)(1) (Supervision).

<sup>336</sup> See Exchange Act Section 17(a).

<sup>337</sup> See Exchange Act Rule 17a-3(a)(17).

business.<sup>342</sup> On the other hand, the limitations of the exclusion show that Congress also recognized certain broker-dealer advisory services belong within the scope of the Advisers Act—namely those for which they receive special compensation and those that are not solely incidental to their regular business as broker-dealers.<sup>343</sup>

The Commission has on many occasions discussed the scope of the broker-dealer exclusion. In particular, the Commission has for many years considered issues related to a broker-dealer's exercise of investment discretion over customer accounts and the extent to which such practices could be considered solely incidental to the business of a broker-dealer. Since at least 1978, the Commission has recognized that the broker-dealer exclusion requires some limitations on a broker-dealer's exercise of investment discretion. At that time, the Commission solicited comment on the question of whether broker-dealers who exercised discretionary authority over customers' accounts should, *per se*, be considered investment advisers with respect to those accounts.<sup>344</sup> While the Commission declined to adopt such an interpretation at that time, it noted that if the business of a broker-dealer consisted almost exclusively of managing accounts on a discretionary basis, the Commission staff would not consider the broker-dealer to be providing investment advice that is solely incidental to its business as a

<sup>342</sup> *Opinion of General Counsel Relating to Section 202(a)(11)(C) of the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 2 (Oct. 28, 1940) (“Advisers Act Release No. 2”).

<sup>343</sup> In 1940, when Congress enacted the Advisers Act, broker-dealers were already regulated under the Exchange Act. In the Advisers Act, Congress expressly acknowledged that the broker-dealers it covered could also be subject to other regulation. 15 U.S.C. 80b–8(b). Judicial interpretation of the broker-dealer exclusion also has noted that Congress passed the Advisers Act to provide certain protections to the public when receiving investment advice and that there is nothing in the legislative history of the Advisers Act “to suggest that Congress was particularly concerned about the regulatory burdens on broker-dealers” associated with their being subject to the Advisers Act in addition to Exchange Act. *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) (“*Financial Planning Association v. SEC*”) (noting additionally that “[j]ust as the text and structure of paragraph 202(a)(11) make it evident that Congress intended to define ‘investment adviser’ broadly and create only a precise exemption for broker-dealers, so does a consideration of the problems Congress sought to address in enacting the IAA” and stating that the Advisers Act sought to address these problems “by establishing a federal fiduciary standard to govern the conduct of investment advisers, broadly defined” and “by requiring full disclosure of all conflicts of interest”).

<sup>344</sup> *Final Extension of Temporary Rules*, Advisers Act Release No. 626 (Apr. 27, 1978) (“Advisers Act Release No. 626”).

broker-dealer.<sup>345</sup> In 2005, the Commission adopted an interpretive rule<sup>346</sup> that, among other things, provided that broker-dealers are not excluded from the Advisers Act for any accounts over which they exercise more than temporary or limited investment discretion.<sup>347</sup> The 2005 interpretation regarding investment discretion was part of a rule whose principal purpose was to permit broker-dealers to offer fee-based brokerage accounts (where a customer pays an asset-based fee) without being subject to the Advisers Act with respect to those accounts.<sup>348</sup> In 2007, the rule was vacated by the U.S. Court of Appeals for the District of Columbia Circuit on the grounds that the Commission did not have the authority to except broker-dealers offering fee-based brokerage accounts from the definition of “investment adviser.”<sup>349</sup> Though the Court did not specifically address the validity of the provision regarding investment discretion, it vacated the entire rule. After the rule was vacated, the Commission proposed in 2007, though did not adopt, a similar interpretive rule regarding investment discretion.<sup>350</sup>

In considering why limitations on broker-dealers' exercise of investment discretion are needed, the Commission has noted that discretionary brokerage relationships “have many of the characteristics of the relationships to which the protection of the Advisers Act are important.”<sup>351</sup> In particular, the Commission has noted that the exercise of investment discretion is qualitatively distinct from simply providing advice as part of a package of brokerage services,

<sup>345</sup> *Applicability of the Investment Advisers Act to Certain Brokers and Dealers*, Investment Advisers Act Release No. 640 (Oct. 5, 1978) [43 FR 47176 (Oct. 13, 1978)] (“Advisers Act Release No. 640”).

<sup>346</sup> Original rule 202(a)(11)–1 under the Advisers Act.

<sup>347</sup> *See Certain Broker-Dealers Deemed Not to be Investment Advisers*, Advisers Act Release No. 2340 (Jan. 6, 2005) (“2005 Proposing Release”); *Certain Broker-Dealers Deemed Not to be Investment Advisers*, Advisers Act Release No. 2376 (Apr. 12, 2005) (“2005 Adopting Release”).

<sup>348</sup> *See* 2005 Adopting Release, *supra* note 347. Fee-based brokerage accounts are similar to traditional full-service brokerage accounts, which provide a package of services, including execution, incidental investment advice, and custody. The primary difference between the two types of accounts is that a customer in a fee-based brokerage account pays a fee based upon the amount of assets on account (an asset-based fee) and a customer in a traditional full-service brokerage account pays a commission (or a mark-up or mark-down) for each transaction.

<sup>349</sup> *See Financial Planning Association v. SEC*, *supra* note 343.

<sup>350</sup> *Interpretive Rule Under the Advisers Act Affecting Broker-Dealers*, Investment Advisers Act Release No. 2652 (Sept. 24, 2007) (“2007 Proposing Release”).

<sup>351</sup> Advisers Act Release No. 626.

because a broker-dealer with such discretion is not just a source of *advice*, but has authority to make investment *decisions* relating to the purchase or sale of securities on behalf of customers.<sup>352</sup> The Commission has stated that the quintessentially supervisory or managerial character of investment discretion warrants the protection of the Advisers Act and its attendant fiduciary duty.<sup>353</sup> This position aligns with the interpretations of the courts, which have generally found that broker-dealers with investment discretion owe customers a fiduciary duty under state law.<sup>354</sup>

At the same time, the Commission has recognized that at least some exercise of discretionary authority by broker-dealers could be considered solely incidental to their business. Under a previous interpretation, a broker-dealer's discretionary account was subject to the Advisers Act only if the broker-dealer had enough other discretionary accounts to trigger the Advisers Act.<sup>355</sup> The interpretive

<sup>352</sup> *See* 2005 Proposing Release; *see also* 2007 Proposing Release.

<sup>353</sup> *See Amendment and Extension of Temporary Exemption From the Investment Advisers Act for Certain Brokers and Dealers*, Investment Advisers Act Release No. 471 (Aug. 20, 1975) (“. . . it is not appropriate to exempt from the Advisers Act for an extended period those brokers and dealers who perform investment supervisory services or other investment management services because of the special trust and confidence inherent in the relationships between such brokers and dealers and their advisory clients.”). *See also* 2005 Proposing Release; 2005 Adopting Release; and 2007 Proposing Release.

<sup>354</sup> *See, e.g., United State v. Skelly*, 442 F.3d 94 at 98 (2d Cir. 2006) (fiduciary duty found “most commonly” where “a broker has discretionary authority over the customer's account”); *United States v. Szur*, 289 F.3d 200 at 211 (2d Cir. 2002) (“Although it is true that there ‘is no general fiduciary duty inherent in an ordinary broker/customer relationship,’ a relationship of trust and confidence does exist between a broker and a customer with respect to those matters that have been entrusted to the broker.”) (citations omitted); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953–54 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981) (stating that courts have held that a broker who has *de facto* control over a non-discretionary account generally owes customer duties of a fiduciary nature; looking to customer's sophistication, and the degree of trust and confidence in the relationship, among other things, to determine duties owed). *See also* Arthur B. Laby, *Fiduciary Duty of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 3 (2010) (“most courts and commentators agree that when a broker has discretionary authority, the broker owes fiduciary duties to its customer”); Barbara Black, *Brokers and Advisers—What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 36 (2005) (stating that broker-dealers generally do not owe a fiduciary duty unless operating with discretion).

<sup>355</sup> A broker-dealer who exercised discretionary authority over the accounts of some of its customers was generally regarded as providing investment advice incidental to its business as a broker-dealer but a broker-dealer whose business consisted almost exclusively of managing accounts on a discretionary basis was not regarded as providing

provision that we adopted in 2005 and proposed in 2007 would have required broker-dealers to be considered to be investment advisers under the Advisers Act with respect to discretionary accounts, except that broker-dealers would have been permitted to exercise investment discretion on a temporary or limited basis.<sup>356</sup>

Although we did not adopt our 2007 proposal, many commenters were generally supportive of our approach.<sup>357</sup> We believe that much of the financial industry has treated broker-dealers as not excluded from the Advisers Act for any accounts over which they exercise more than temporary or limited investment discretion. Most commenters to the Chairman's recent request for comment, including broker-dealers, have indicated that financial firms generally treat discretionary accounts as advisory accounts.<sup>358</sup>

Our staff acknowledged that broker-dealers may provide some discretionary

advice solely incidental to his business as a broker-dealer. See Advisers Act Release No. 626.

<sup>356</sup> The Commission stated that it would view a broker-dealer's discretion to be temporary or limited within the meaning of proposed rule 202(a)(11)-1(d) when the broker-dealer was given discretion: (i) As to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security; (ii) on an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time not to exceed a few months; (iii) as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent; (iv) to purchase or sell securities to satisfy margin requirements; (v) to sell specific bonds and purchase similar bonds in order to permit a customer to take a tax loss on the original position; (vi) to purchase a bond with a specified credit rating and maturity; and (vii) to purchase or sell a security or type of security limited by specific parameters established by the customer. See 2005 Proposing Release; 2005 Adopting Release; 2007 Proposing Release. In the 2005 Adopting Release, we noted that accounts in which broker-dealers exercised such investment discretion would continue to be subject to the existing Exchange Act and SRO rules concerning broker-dealer exercise of investment discretion. See 2005 Adopting Release.

<sup>357</sup> See, e.g., Letter of the Consumer Federation of America and Fund Democracy (Nov. 2, 2007); Letter of the Investment Adviser Association (Nov. 2, 2007); Letter of Charles McKeown (Oct. 30, 2007); and Letter of the Securities Industry and Financial Markets Association (Nov. 2, 2007).

<sup>358</sup> See T. Rowe Letter; Stifel Letter ("In simple terms, Brokerage relationships are non-discretionary, commission-based accounts, through which a financial professional provides episodic investment advice incidental to each transaction. By contrast, in an Advisory relationship, a financial professional generally provides ongoing investment advice and monitoring and charges a level fee, generally based on assets."); see ICI August 2017 Letter ("broker-dealers typically do not exercise discretionary authority over customer accounts"); Vanguard Letter ("The investment advisory business model is significantly different from that of a broker-dealer. Advisers generally provide ongoing advice for a fee, take discretion over client accounts, and engage other entities to carry client accounts and handle client trading.").

account services in the 913 Study.<sup>359</sup> We have also long recognized that a broker-dealer's ability to engage in discretionary activity is circumscribed by existing rules under the federal securities laws.<sup>360</sup> In addition, broker-dealers that engage in any discretionary activity are subject to SRO Rules that prohibit and require specific conduct with respect to discretionary accounts.<sup>361</sup> Further, broker-dealers vested with discretionary authority or that exercise control over customer assets have been held to a fiduciary standard under state law.<sup>362</sup>

We believe that it is appropriate for the Commission to again consider the scope of the broker-dealer exclusion with regard to a broker-dealer's exercise of investment discretion in light of both proposed Regulation Best Interest and the proposed Relationship Summary. Additionally, some commenters to the Chairman's request asked that we expressly affirm the interpretive provision we adopted in 2005 and proposed in 2007.<sup>363</sup>

In light of the foregoing, we request comment on the following:

- Should a broker-dealer's provision of unfettered discretionary investment advice be considered solely incidental to the conduct of its business as a broker-dealer?
- Should a broker-dealer's provision of limited discretionary investment advice be considered solely incidental to the conduct of its business as a broker-dealer? If so, what limitations on a broker-dealer's exercise of investment discretion would make it solely incidental to the conduct of its business as a broker-dealer?
- Should we propose an interpretive rule placing express limits on investment discretion permissible under the solely incidental exclusion as we

<sup>359</sup> See 913 Study at 9-10.

<sup>360</sup> See, e.g., Exchange Act Section 3(a)(35) (defining investment discretion). 17 CFR 240.15c1-7.

<sup>361</sup> See NASD Rule 2510 (Discretionary Accounts) and Incorporated NYSE Rule 408 (Discretionary Power in Customers' Accounts). Drawing upon the requirements of these rules and SRO suitability rules, the Commission has found the exercise of discretion over a customer's account may constitute a "recommendation" that additionally subjects a broker-dealer's discretionary activity to SRO suitability requirements. See, e.g., *In re Application of Paul C. Kettler*, Exchange Act Release No. 31354, 1992 WL 320802, \*3, n.11 (1992). See also *In re James Harman McNeill*, (Case No. 2012030927101, AWC, Mar. 12, 2013), available at [http://www.finra.org/sites/default/files/fda\\_documents/2012030927101\\_FDA\\_TP44051.pdf](http://www.finra.org/sites/default/files/fda_documents/2012030927101_FDA_TP44051.pdf) (associated person violated FINRA Rule 2510(b) by exercising discretion in five customers' brokerage accounts without the written authorization of the customers). See also *supra* note 139 and accompanying text.

<sup>362</sup> See *supra* note 15.

<sup>363</sup> IAA Letter; CFA 2017 Letter.

did in 2007? What would be the consequences of such a rule?

- In 2007, we proposed to permit broker-dealers to exercise investment discretion granted by a customer on a temporary or limited basis. Is that appropriate? Would it provide the intended investor protection? Would it provide the clarity regarding the applicable business model and standard of care?

- In 2007 we provided examples of when we would consider a broker-dealer's investment discretion to be temporary or limited.<sup>364</sup> Should we define situations in which investment discretion should be viewed as being granted on a temporary or limited basis? For example, should temporary investment discretion last no more than a very limited time (*i.e.*, not as long as two or more months)? Should we restrict a broker-dealer's ability to exercise temporary investment discretion repeatedly? Should limited discretion "to purchase or sell a security or type of security limited by specific parameters established by the customer" be restricted?<sup>365</sup> What are some examples of specific parameters that a customer could establish under this example? Should we expand any of the situations in which investment discretion could be viewed as being granted on a temporary or limited basis? For example, should we explicitly allow brokers to exercise investment discretion granted by the customer to rebalance the customer's account or to invest a limited portion of the account in a particular sector?

- Do broker-dealers generally use the examples from the 2007 release to determine when to seek authorization to exercise temporary or limited investment discretion from a customer? Are there other circumstances that cause broker-dealers to seek authorization to exercise investment discretion?

- The Commission requests data and other information related to the nature and magnitude of discretionary services offered by broker-dealers. To what extent do broker-dealers offer a range of discretionary brokerage accounts? What is the range of discretionary services offered, and what types of limits do broker-dealers apply to such services?

- We understand that dually-registered firms generally treat discretionary accounts as advisory accounts. Is this understanding correct? To what extent and under what circumstances do broker-dealers treat discretionary accounts as brokerage accounts? If broker-dealers offer

<sup>364</sup> See *supra* note 356.

<sup>365</sup> *Id.*

discretionary management in brokerage accounts, who are the typical investors in those accounts?

- Section 3(a)(35) of the Exchange Act defines “investment discretion.”<sup>366</sup> Should we consider a different, narrower definition of discretionary management that would be deemed solely incidental to the brokerage business?

- Do broker-dealers rely on the staff’s 2005 statement that it would not deem a broker-dealer to exercise investment discretion for purposes of the then existing Advisers Act rule 202(a)(11)–1 as a result of the exercise of investment discretion by one of its associated persons over a “related account”?<sup>367</sup>

- We are concerned that any approach to the broker-dealer exclusion in the Advisers Act that would permit broker-dealers unlimited investment discretion could increase incentives for improper conduct, particularly the incentive to churn accounts because broker-dealers receive transactional compensation. To what extent would permitting broker-dealers to exercise unlimited investment discretion increase the risk of such conduct? Are there protections in addition to those already in place, or limitations on the permissible use of investment discretion, that we could take to reduce such risks? To what extent would subparagraph (a)(2)(i)(C) of proposed Regulation Best Interest reduce such risks?

- To what extent does broker-dealers’ exercise of investment discretion for their customers increase investor choice in financial services? What are the benefits and risks to investors? How could the risks be addressed through regulation, including Regulation Best Interest?

<sup>366</sup> 15 U.S.C. 78c(a)(35). Under Exchange Act Section 3(a)(35), a person exercises “investment discretion” with respect to an account if, “directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even through some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.”

<sup>367</sup> A “related account” is an account where the associated person’s discretionary authority stems from his or her serving as executor, conservator, trustee, attorney-in-fact or other agent as a result of a family or personal relationship, and not from employment with the broker-dealer. No-Action Letter Under Investment Advisers Act of 1940—Rule 202(a)(11)–1 (Nov. 17, 2005), available at <https://www.sec.gov/divisions/investment/noaction/morganlewis111705.htm>.

- The Commission also requests commenters’ views on potential opportunities for broker-dealers to offer discretionary brokerage services in the future. To what extent would broker-dealers anticipate offering additional discretionary brokerage services?

- As discussed in this release and the Relationship Summary Proposal, investors are often confused by the differences between advisory and brokerage accounts. Would drawing a specific distinction between discretionary and non-discretionary accounts resolve some of this confusion?

### III. Request for Comment

The Commission requests comments on all aspects of Regulation Best Interest. The Commission particularly requests comment on the general impact the proposal would have on recommendations to retail customers and on the behavior of broker-dealers, including the interaction of Regulation Best Interest with the requirements of the Relationship Summary Proposal. The Commission also seeks comment on the interaction of Regulation Best Interest with FINRA and other SRO rules, the antifraud provisions of the federal securities laws, the Advisers Act, ERISA, and the Code. In addition, the Commission seeks comment on the following specific issues:

#### A. Generally

- Does Regulation Best Interest clearly define the obligations to which broker-dealers would be subject? Are there clarifications or instructions to the proposed requirements that would aid broker-dealers’ compliance with the proposed rule? If so, what are they, and what would be the benefits of providing clarifications or instructions?

- As proposed, compliance with paragraph (a)(2) of Regulation Best Interest is designed to satisfy the duty in (a)(1). Is this the right relationship between these two pieces? Should paragraph (a)(2) be expressed as a minimum standard? Or should the duty in expressed in paragraph (a)(1) have residual force and effect apart from the obligations in (a)(2)? Alternatively, should compliance with (a)(2) be a safe harbor? Or should it create a legal presumption that the broker-dealer has met the standard in (a)(1)? Should the Commission create a compliance safe harbor for Regulation Best Interest? Why or why not? If so, what conditions should a broker-dealer be required to satisfy to claim the safe harbor? What impact would this have on the recommendations that retail customers receive?

- Should broker-dealers be subject to any additional requirements with respect to the best interest obligation proposed under Regulation Best Interest? If so, what requirements and why?

- Should the Commission require policies and procedures to assist with compliance with Regulation Best Interest? If so, how would those policies and procedures differ, if at all, from those currently required by FINRA?

- Should the Commission consider making other adjustments to the regulatory obligations of broker-dealers, and if so, which obligations?

- Should the Commission include in the rule text the interpretations and recommendations included in the guidance provided above? If so, which interpretations and recommendations and why or why not?

- Do commenters believe any of the proposed definitions under Regulation Best Interest should be eliminated or modified? Are there any additional terms that should be defined; if so, what are those terms, how should such terms be defined, and why?

- To what extent would Regulation Best Interest help address any investor confusion about the standard of conduct that applies when a broker-dealer provides advice in the form of recommendations? What, if any, other steps should the Commission consider to attempt to mitigate investor confusion?

- What impact would Regulation Best Interest have on the range of choice—both in terms of services related to advice and products—that is available to brokerage retail customers today? Would it preserve such choice? What, if any, additional or different steps should the Commission consider to attempt to preserve choice or mitigate any negative impact on the range of choice available to brokerage customers to receive financial advice?

- What impact would Regulation Best Interest have on the ability of broker-dealers to compete with other financial intermediaries to provide advice to investors in the future?

- To what extent would Regulation Best Interest be consistent with relevant SRO requirements? Would Regulation Best Interest be stricter or less strict than SRO obligations? Would Regulation Best Interest conflict with or be redundant of SRO obligations; if so, please identify which SRO obligations and whether and how the Commission should consider to address such conflicts or redundancies.

- Is it appropriate for Regulation Best Interest to be designed to be generally consistent with DOL and SRO

regulations? Why or why not? Should we take a different approach?

- Does proposed Regulation Best Interest address current deficiencies in the current standard applicable to broker-dealers who provide advice? Why or why not? Please explain.

- Are there any recommendations in the 913 Study that should be, but have not been, incorporated into the proposed rule? Please elaborate.

- To what extent is the proposed Regulation Best Interest consistent or inconsistent with broker-dealers' existing obligations? How? What impact would such consistency or inconsistency have on retail customers and broker-dealers?

#### *B. Interactions With Other Standards of Conduct*

- Are there any specific interactions or relationships between the proposed rules and other federal securities laws that should be addressed?

- Are there any specific interactions between the proposed rules and other regulatory requirements, such as SRO rules or state securities laws that should be addressed?

- Are there any specific interactions between the proposed rules and any non-securities statutes and regulations (e.g., ERISA and the Code) that should be addressed? If so, how should those interactions or relationships be addressed or clarified?

- Do any of the proposed requirements conflict with any existing requirements, including any requirement currently imposed by an SRO or by a state regulator, such that it would be impractical or impossible for a broker-dealer to meet both obligations? If so, which one(s) and why?

- Do commenters agree that proposed Regulation Best Interest is consistent with and similar to (if not the same as) related obligations under the duties of loyalty and care as interpreted under the Advisers Act? Why or why not? Please explain.

- If the Commission were to adopt this proposal, there would still be different standards of conduct for retail customer accounts subject to the DOL Fiduciary Rule and those that are not, as well as existing differences between standards of conduct applicable to broker-dealers and those applicable to investment advisers when providing investment advice. Should the Commission consider harmonizing regulatory obligations related to the provision of advice that are applicable to broker-dealers and investment advisers? Why or why not? If so, how so? Please be specific with regard to the

existing obligations and how they should be changed.

- To what extent would regulatory harmonization address investors' confusion about the obligations owed to them by broker-dealers and investment advisers? To what extent would regulatory harmonization result in additional investor confusion or otherwise negatively impact investors? What would be positive and negative investor impacts of regulatory harmonization? To what extent would regulatory harmonization affect investors' choice of financial firms and options to pay for financial advice? Please explain.

- Are there any specific interactions between Regulation Best Interest and state standards that should be addressed? What have commenters' experiences been with respect to current state fiduciary standards (regulatory and common law) for broker-dealers that provide investment advice? How are these standards similar or different than this proposal? What are commenters' views regarding proposed state fiduciary standards for broker-dealers?

#### **IV. Economic Analysis**

##### *A. Introduction, Primary Goals of Proposed Regulations and Broad Economic Considerations*

###### **1. Introduction and Primary Goals of Proposed Regulation**

The Commission is mindful of the costs imposed by, and the benefits obtained from, our rules. Whenever the Commission engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, Section 3(f) of the Exchange Act requires the Commission to consider whether the action would promote efficiency, competition, and capital formation, in addition to the protection of investors.<sup>368</sup> Further, when making rules under the Exchange Act, Section 23(a)(2) of the Exchange Act requires the Commission to consider the impact such rules would have on competition.<sup>369</sup> Section 23(a)(2) of the Exchange Act also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>370</sup> The following analysis considers, in detail, the potential economic effects that may result from proposed Regulation Best Interest, including the benefits and costs to retail

customers and broker-dealers as well as the broader implications of the proposal for efficiency, competition, and capital formation.

Where possible, the Commission quantifies the likely economic effects of proposed Regulation Best Interest; however, as explained further below, the Commission is unable to quantify certain economic effects because it lacks the information necessary to provide reasonable estimates. In some cases, quantification is particularly challenging due to the difficulty of predicting how market participants would act under the conditions of the proposed rule. Nevertheless, as described more fully below, the Commission is providing both a qualitative assessment and quantified estimate of the potential effects, including the potential aggregate initial and aggregate ongoing costs, where feasible. The Commission encourages commenters to provide data and information to help quantify the benefits, costs, and the potential impacts of the proposed rule on efficiency, competition, and capital formation.

###### **2. Broad Economic Considerations**

###### **a. The Principal-Agent Relationship**

The relationship between a retail customer and a broker-dealer is an example of what is referred to in economic theory as an "agency" relationship. In an agency relationship, one party, commonly referred to as "the principal," engages a second party, commonly referred to as "the agent," to perform some service on the principal's behalf.<sup>371</sup> Because the agent and the principal are likely to have different preferences and goals, there is reason to believe that the agent may not always take actions that are in the principal's interest.<sup>372</sup> This divergence in interests gives rise to agency problems: Agents take actions that increase their well-being at the expense of principals.<sup>373</sup>

<sup>371</sup> For example, James A. Brickley, Clifford W. Smith, Jr., Jerold L. Zimmerman, "Managerial Economics and Organizational Architecture" (2004, p. 265), "An agency relationship consists of an agreement under which one party, the principal, engages another party, the agent, to perform some service on the principal's behalf." See also Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* (1976, vol. 3, pp. 305-60).

<sup>372</sup> See Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* (1976, vol. 3, p. 308).

<sup>373</sup> See James A. Brickley, Clifford W. Smith, Jr., Jerold L. Zimmerman, "Managerial Economics and Organizational Architecture" (2004, p. 265).

<sup>368</sup> See 15 U.S.C. 77b(b) and 15 U.S.C. 78c(f).

<sup>369</sup> See 15 U.S.C. 78w(a)(2).

<sup>370</sup> *Id.*



Retail customers face agency problems when they seek advice from financial professionals. For example, a retail customer may believe that a broker-dealer will exert a high level of effort on a retail customer's behalf to identify a security that helps the retail customer meet her objectives. But to the extent that effort is costly to the broker-dealer and the benefits of the recommendation accrue solely to the retail customer, the broker-dealer has an incentive to exert a lower level of effort than the retail customer expects.<sup>374</sup> In this section, we describe how principals (customers) and agents (broker-dealers and associated persons) ameliorate agency problems in the market for investment advice using contracts and discuss limits to the efficiency of contracting in the market for financial advice.

Contracts are a common mechanism used by principals and agents to ameliorate agency problems. They do so by explicitly setting out the responsibilities of both parties under the contract. Typically, in return for compensation from the principal, an agent agrees to perform certain actions that will benefit the principal. For example, in a typical contract between a broker-dealer and a retail customer, the broker-dealer agrees to provide execution services in return for compensation in the form of either a commission or a markup. The contract ameliorates the conflict between the two parties because the broker-dealer is compensated only if it provides the contracted service.

Explicit contracting is an efficient mechanism for ameliorating agency costs when the principal can monitor the agent's performance at low cost. For certain services, however, it may be difficult or costly for principals to monitor agent performance. For example, in seeking investment advice, retail customers may expect broker-dealers to understand the potential risks and rewards associated with a recommended transaction or strategy. While it might be possible, in theory, to include such an explicit provision in the contract between the customer and the broker-dealer to this effect, it would be difficult for the customer to confirm the broker-dealer's actual understanding. The inability of the customer to confirm the broker-dealer's actual understanding limits the usefulness of such a provision in

<sup>374</sup> Other manifestations of the agency conflict between broker-dealers and customers include conflicts that arise when broker-dealers act as principal (e.g., proprietary products, principal trades) or when the broker-dealer opts to enter into relationships with third parties (e.g., revenue sharing) that creates their own conflicts.

ameliorating the agency conflict between the customer and the broker-dealer.

Another factor that determines the effectiveness of explicit contracting and monitoring by the principal is the ability of the principal to accurately measure and assess the actions of the agent.<sup>375</sup> For example, customers may expect advice that is tailored to their specific investment objectives, financial situation, and needs. Contracts between customers and broker-dealers could include explicit provisions to this effect. However, customers may lack the knowledge required to assess whether a recommendation is appropriate for their needs, given their particular situation. As a result, while such an explicit provision could be included in a contract between a retail customer and a broker-dealer, it would be of limited value in ameliorating the agency conflict between the two.

Finally, we note that beyond the agency costs described above, there are costs associated with specifying the contractual terms themselves. Specifying contractual terms potentially involves forecasting all future states of the world that are relevant to the contractual relationship and specifying the parties' obligations in each of those states. In environments as complex as financial markets, the ability to forecast future states may be especially difficult. Further, even if financial firms and retail customers were able to forecast all future states of the world relevant to their relationship, the process of contractually specifying each state and the financial firm's obligation to a retail customer in each of those states could be very costly.<sup>376</sup>

As an alternative to explicit contracting and monitoring by principals, agents can expend resources (i.e., "bonding costs") to guarantee their fulfillment of contractual terms or to ensure that the principal will be compensated if the agents fail to meet their obligations.<sup>377</sup> As we noted above,

<sup>375</sup> See Frank H. Easterbrook and Daniel R. Fischel, "Contract and Fiduciary Duty," *Journal of Law & Economics* (1993, vol. 36, p. 426) ("Contract and Fiduciary Duty").

<sup>376</sup> See Frank H. Easterbrook and Daniel R. Fischel, "The Economic Structure of Corporate Law" (1991, p. 90). See also "Contract and Fiduciary Duty." The authors note that parties to the contract are likely not able to see future possibilities well enough to specify all contingencies ahead of time.

<sup>377</sup> For example, agents might bond themselves by purchasing insurance policies that pay the principal in the case of theft. See James A. Brickley, Clifford W. Smith, Jr., Jerold L. Zimmerman, "Managerial Economics and Organizational Architecture" (2004, p. 265). The agent is willing to incur bonding costs to increase the amount paid to the agent by the principal for the agent's services.

customers would like broker-dealers to understand the potential risks and rewards associated with a recommended transaction or strategy. For example, and if consistent with applicable legal limitations, the contract between the customer and broker-dealer could include a provision in which the broker-dealer agrees to compensate the retail customer if the broker-dealer does not have the level of understanding promised under the contract. Unfortunately, factors that limit the effectiveness of explicit contracting and monitoring by principals also tend to limit the effectiveness of explicit contracting and bonding by agents. For example, a broker-dealer's actual level of understanding is difficult to confirm. The difficulty in confirming a broker-dealer's understanding would cause any promise to compensate the customer if the broker-dealer did not understand the potential risks and rewards associated with a recommended transaction or strategy to be of limited value.

In situations where the costs of explicit contracting and monitoring and bonding are large, or where the cost of writing and enforcing contracts is large, a legal or regulatory standard of conduct can serve as an alternative mechanism for ameliorating agency costs.<sup>378</sup> Under a legal or regulatory standard of conduct, agents are obligated to act in the principal's interest with the standard of conduct defining how that obligation is to be met. For example, as noted above, retail customers would like broker-dealers to understand the potential risks and rewards associated with a recommended transaction or strategy as well as for the broker-dealer to tailor recommendations to the retail customer's specific investment objectives, financial situation, and needs. It would be difficult to stipulate those requirements in an explicit contract between a broker-dealer and a retail customer because such contract would be difficult to monitor and enforce. In particular, under private contracting, deterring broker-dealers from not acting in the retail customer's interest could be difficult. A standard of conduct that requires broker-dealers to act in the retail customer's best interest provides an alternative mechanism that is designed to result in the broker-dealer providing services at a level of quality

<sup>378</sup> In a world of scarce information and high transactions costs, regulation can promote the efficiency of contracting between parties by prescribing the outcomes the parties themselves would have reached had information been plentiful and negotiations costless. See "Contract and Fiduciary Duty" and R. H. Coase, "The Problem of Social Cost," *Journal of Law & Economics* (1960, vol. 3, pp. 1-44).

that better matches the expectations of its retail customers. In particular, broker-dealers would face regulatory liability if they failed to meet their obligation to act in the retail customer's interest under the standard of conduct. Relative to private contracting, a standard of conduct may be more effective in deterring broker-dealers from acting in their own interest rather than the retail customer's interest.

Regulation Best Interest would create a minimum professional standard of conduct for broker-dealers under the Exchange Act that is designed to ameliorate the agency costs associated with conflicts between broker-dealers and their retail customers. It would also articulate the role of regulators in enforcing such standard of conduct. As a result, the firm's legal and regulatory obligations would be designed to result in the firm providing advice at a level of quality that better matches the expectations of its retail customers.

In the absence of some form of amelioration, the agency conflicts between broker-dealers and retail customers may influence the advice that retail customers obtain in a number of ways. In the narrow context of a choice between two products with similar expected returns and risk profiles, but with different commissions, an agency conflict leaves the retail customer no worse off in terms of investment outcomes except to the extent that higher commissions result in total returns that are lower on one product than on the other. Under other circumstances, however, an agency conflict may impose greater or different costs on retail customers and, more generally, on financial markets.

For example, a financial firm that is able to systematically choose a higher fee product to recommend to its retail customers may rationally respond by constructing a menu of offerings that permit it to choose to recommend products that yield the firm higher expected payoffs. However, such menus may restrict retail customer access to financial products that are equally suitable but that could provide retail customers with better risk-return profiles. Agency conflicts that arise from material conflicts of interest may similarly cause financial firms to limit the choices available to retail customers. Financial firms may have incentives to prefer proprietary products or products of affiliates over more conventional products that may be equally suitable for the retail customers, but potentially more beneficial for the firms.

Furthermore, the ability of financial firms to act on conflicts may have repercussions for retail customer

welfare if it erodes retail customer trust in financial markets or the market for financial advice. As noted in the Relationship Summary Proposal, evidence suggests a relatively low level of financial literacy among retail customers.<sup>379</sup> Retail customers who are aware that financial firms are likely to be conflicted may choose not to seek advice even when conflicted advice would make them better off than no advice at all. If the presence of conflicts of interest reduces retail customer trust, retail customers, out of abundance of caution may forgo valuable investment opportunities.<sup>380</sup> By contrast, disclosure of conflicts of interest and disclosure of measures taken to mitigate conflicts of interest could have the opposite effect by bolstering investor trust.

#### b. Effects of the Best Interest Standard on the Agency Relationship

As discussed above, there are significant investor protections offered by a best interest standard of conduct approach to addressing the principal-agent issue. However, it is important to note that both parties potentially benefit from the reduction of agency costs. As an initial matter, both retail customers and financial firms enter into an agency relationship only when both sides expect the relationship will make them better off. Generally, both parties enter into a contracting relationship when the retail customer values the financial firm's services at a value that is greater than the minimum price at which the financial firm is willing to supply them (the financial professional's "reservation price").<sup>381</sup> The difference between the retail customer's willingness to pay and the financial firm's reservation price represents the "gains from trade" associated with the contracting relationship. How these gains from trade are shared between the retail customer and the broker-dealer depends on a variety of factors, including the competitiveness of the market for financial advice, and the ability of broker-dealers to exploit their

informational advantage over retail customers.

To make this concrete, consider a situation where a principal values the agent's services at \$10,000 and the minimum price at which the agent is willing to provide the service is \$5,000.<sup>382</sup> The difference between the principal's valuation of the agent's services and the minimum price at which the agent is willing to supply the services represents potential gains from trade to be shared between the two parties. In this case, the gains from trade would be \$5,000 (= \$10,000 - \$5,000).<sup>383</sup>

Suppose, however, that the principal recognizes that the agent's preferences are not perfectly aligned with her own and that given the difference in preferences the principal revises her expectation of the agent's behavior, and therefore the valuation of the agent's services, to \$7,000. The potential gains from trade have been reduced from \$5,000 to \$2,000. The \$3,000 reduction in gains from trade is a real cost of the agency conflict between the two parties.<sup>384</sup> If gains from trade are shared between both parties, both parties have an incentive to ameliorate the agency conflict so as to maximize the potential gains from trade to be shared between the two.

Suppose further that the two parties could agree to a contract with explicit provisions that would ameliorate the agency conflict to such a degree that the principal would believe the agent's services to be worth \$9,000. Further, suppose that the contract has associated costs of \$500.<sup>385</sup> It would be in both parties' interests to use the contract because it would increase the gains from trade to be shared between the two from \$2,000 to \$3,500 (= \$9,000 - \$5,000 - \$500).

However, contracts may be inefficient under certain circumstances. For example, suppose there existed additional contract provisions that could further ameliorate the agency conflict to a degree that the principal would believe that the agent's services to be worth an additional \$500, or \$9,500 in total (= \$9,000 + \$500), but that those provisions cost \$750 to implement. In this case, it would not be in the parties' interests to engage in those additional contracting provisions

<sup>379</sup> See Relationship Summary Proposal. See, e.g., Staff of the Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Aug. 2012), at iv, v, xiv, 37, 73, 121-23 and 131-32, available at <https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf> ("917 Financial Literacy Study")

<sup>380</sup> See Ko, K. Jeremy, "Economics Note: Investor Confidence," Oct. 2017, available at [https://www.sec.gov/files/investor\\_confidence\\_noteOct2017.pdf](https://www.sec.gov/files/investor_confidence_noteOct2017.pdf).

<sup>381</sup> See James A. Brickley, Clifford W. Smith, Jr., Jerold L. Zimmerman, "Managerial Economics and Organizational Architecture" (2004, p. 45).

<sup>382</sup> These numbers are provided only as an illustrative example and are not meant to convey the costs of financial services.

<sup>383</sup> See *supra* note 380.

<sup>384</sup> From the example, it should be clear that agency costs can, potentially, rise to such a level that the gains from trade are completely wiped out and trade does not occur.

<sup>385</sup> That is, the sum of the monitoring, bonding, and contract specifications costs is \$500.

because it would result in a reduction in gains from trade from \$3,500 to \$3,250 (= \$9,500 – \$5,000 – \$500 – \$750).

Importantly, this example does not reflect the types of factors that can impact how these gains from trade will be shared. For example, broker-dealers may have an informational advantage that could allow them to maintain a large share of the gains of trade that flow from their relationship with retail customers. We understand that retail customers generally do not know the structure of mutual fund fees or how much is remitted back to broker-dealers recommending those funds. The proposed rule would no longer make it possible for the broker-dealer to make a recommendation solely based on the portion of fees that flow back to the broker-dealer, thereby reducing the share of the gains from trade that broker-dealers are currently able to retain. In response, broker-dealers may try to recoup this loss by increasing the fees for recommendations to retail customers. Fees that broker-dealers charge to retail customers, unlike the compensation that broker-dealers extract from product sponsors, are generally required to be disclosed. To the extent that retail customers are sensitive to fee increases (e.g., may switch to another, lower-cost broker-dealer) broker-dealers may not be able to reverse the loss in gains from trade through a fee increase. Thus, the degree of competition among broker-dealers may limit the extent to which a broker-dealer can recoup these losses. As a result, if the market for broker-dealer advice is sufficiently competitive, the gains from trade that result from the proposed rule would mostly flow to retail customers.

Therefore, a standard of conduct may be an efficient alternative to the costly explicit contracting illustrated above. We acknowledge, however, that standards also can be costly. In the analysis that follows in Section C below, we characterize the benefits and costs associated with the proposed best interest standard of conduct and their resulting effect on the gains from trade to be shared between broker-dealers and their retail customers.

## B. Economic Baseline

### 1. Market for Advice Services<sup>386</sup>

#### a. Broker-Dealers

The Commission analyzed the effect of proposed Regulation Best Interest on

<sup>386</sup> In addition to broker-dealers and Commission-registered investment advisers discussed below in the baseline, there are a number of other entities, such as state registered investment advisers, commercial banks, and insurance companies,

the market for broker-dealer services. For simplification, the Commission presents its analysis as if the market for broker-dealer services encompasses one broad market with multiple segments, even though, in terms of competition, it may be more realistic to think of it as numerous interrelated markets. The market for broker-dealer services covers many different markets for a variety of services, including, but not limited to, managing orders for customers and routing them to various trading venues; providing advice to retail customers on an episodic, periodic, or ongoing basis; holding retail customers' funds and securities; handling clearance and settlement of trades; intermediating between retail customers and carrying/clearing brokers; dealing in government bonds; privately placing securities; and effecting transactions in mutual funds that involve transferring funds directly to the issuer. Some broker-dealers may specialize in just one narrowly defined service, while others may provide a wide variety of services.

As of December 2017, there were approximately 3,841 registered broker-dealers with over 130 million customer accounts. In total, these broker-dealers have close to \$4 trillion in total assets, which are total broker-dealer assets as reported on Form X-17a-5.<sup>387</sup> More than two-thirds of all brokerage assets and close to one-third of all customer accounts are held by the 16 largest broker-dealers, as shown in Table 1, Panel A.<sup>388</sup> Of the broker-dealers registered with the Commission as of December 2017, 366 broker-dealers were dually-registered as investment

which also provide financial advice services to retail customers. A number of broker-dealers (see *infra* note 391) have non-securities businesses, such as insurance or tax services; however, the Commission is unable to estimate the number of other entities that are likely to provide financial advice to retail customers. As of January 2018, there were approximately 17,800 state-registered investment advisers, of which 145 are also registered with the Commission, as reported on Form ADV Item 2.A. The Department of Labor in its Regulatory Impact Analysis identifies approximately 398 life insurance companies that could provide advice to retirement investors. See *infra* note 453.

<sup>387</sup> Assets are estimated by Total Assets (allowable and non-allowable) from Part II of the FOCUS filings (Form X-17A-5 Part II, available at [https://www.sec.gov/files/formx-17a-5\\_2.pdf](https://www.sec.gov/files/formx-17a-5_2.pdf)) and correspond to balance sheet total assets for the broker-dealer. The Commission does not have an estimate of the total amount of customer assets for broker-dealers. We estimate broker-dealer size from the total balance sheet assets as described above.

<sup>388</sup> Approximately \$3.91 trillion of total assets of broker-dealers (98%) are at firms with total assets in excess of \$1 billion. Of the 30 dual registrants in the group of broker-dealers with total assets in excess of \$1 billion, total assets for these dual registrants are \$2.46 trillion (62%) of aggregate broker-dealer assets. Of the remaining 88 firms, 81 have affiliated investment advisers.

advisers;<sup>389</sup> however, these firms hold nearly 90 million (68% of) customer accounts.<sup>390</sup> Approximately 546 broker-dealers (14%) reported at least one type of non-brokerage business, including insurance, retirement planning, mergers & acquisitions, and real estate, among others.<sup>391</sup> Approximately 74% of registered broker-dealers report retail customer activity.<sup>392</sup>

Panel B of Table 1 limits the broker-dealers to those that report some retail customer activity. As of December 2017,

<sup>389</sup> Because this number does not include the number of broker-dealers who are also registered as state investment advisers, it undercounts the full number of broker-dealers that operate in both capacities. Further, not all firms that are dually-registered as an investment adviser and a broker-dealer offer both brokerage and advisory accounts to retail investors—for example, some dual registrants offer advisory accounts to retail investors but offer brokerage services, such as underwriting services, only to institutional customers. For purposes of the discussion of the baseline in this economic analysis, a dual registrant is any firm that is dually-registered with the Commission as an investment adviser and a broker-dealer. For the purposes of proposed Regulation Best Interest, however, we propose to define dual registrant as a firm that is dually-registered as a broker-dealer and an investment adviser and offers services to retail investors as both a broker-dealer and investment adviser.

<sup>390</sup> Some broker-dealers may be affiliated with investment advisers without being dually-registered. From Question 10 on Form BD, 2,145 broker-dealers (55.8%) report that directly or indirectly, they either control, are controlled by, or under common control with an entity that is engaged in the securities or investment advisory business. Comparatively, 2,478 (19.57% of) SEC-registered investment advisers report an affiliate that is a broker-dealer in Section 7A of Schedule D of Form ADV, including 1,916 SEC-registered investment advisers that report an affiliate that is a registered broker-dealer. Approximately 75% of total assets under management of investment advisers is managed by these 2,478 investment advisers.

<sup>391</sup> We examined Form BD filings to identify broker-dealers reporting non-securities business. For the 546 broker-dealers reporting such business, staff analyzed the narrative descriptions of these businesses on Form BD, and identified the most common types of businesses: Insurance (208), management/financial/other consulting (101), advisory/retirement planning (80), mergers & acquisitions (71), foreign exchange/swaps/other derivatives (31), real estate/property management (31), tax services (15), and other (141). Note that a broker-dealer may have more than one line of non-securities business.

<sup>392</sup> The value of customer accounts is not available from FOCUS data for broker-dealers. Therefore, to obtain estimates of firm size for broker-dealers, we rely on the value of broker-dealers' total assets as obtained from FOCUS reports. Retail sales activity is identified from Form BR, which categorizes retail activity broadly (by marking the "sales" box) or narrowly (by marking the "retail" or "institutional" boxes as types of sales activity). We use the broad definition of sales as we preliminarily believe that many firms will just mark "sales" if they have both retail and institutional activity. However, we note that this may capture some broker-dealers that do not have retail activity, although we are unable to estimate that frequency. We request comment on whether firms that intermediate both retail and institutional customer activity generally market only "sales" on Form BR.

there were approximately 2,857 broker-dealers that served retail customers, with over \$3.6 trillion in assets (90 of total broker-dealer assets) and almost 128 million (96 of) customer accounts.<sup>393</sup> Of those broker-dealers serving retail customers, 360 are dually-registered as investment advisers.<sup>394</sup>

TABLE 1, PANEL A—REGISTERED BROKER-DEALERS AS OF DECEMBER 2017<sup>395</sup>  
CUMULATIVE BROKER-DEALER TOTAL ASSETS AND CUSTOMER ACCOUNTS<sup>396</sup>

Size of broker-dealer (total assets)	Total number of BDs	Number of dual-registered BDs	Cumulative total assets (billion)	Cumulative number of customer accounts <sup>397</sup>
> \$50 billion	16	10	\$2,717	40,969,187
\$1 billion to \$50 billion	102	20	1,196	81,611,933
\$500 million to \$1 billion	38	7	26	4,599,330
\$100 million to \$500 million	118	26	26	1,957,981
\$10 million to \$100 million	482	94	17	2,970,133
\$1 million to \$10 million	1,035	141	4	233,946
< \$1 million	2,055	68	1	5,588
Total	3,841	366	3,987	132,348,098

TABLE 1, PANEL B—REGISTERED RETAIL BROKER-DEALERS AS OF DECEMBER 2017  
CUMULATIVE BROKER-DEALER TOTAL ASSETS AND CUSTOMER ACCOUNTS

Size of broker-dealer (total assets)	Total number of BDs	Number of dual-registered BDs	Cumulative total assets (billion)	Cumulative number of customer accounts
> \$50 billion	15	10	\$2,647	40,964,945
\$1 billion to \$50 billion	70	19	923	77,667,615
\$500 million to \$1 billion	23	7	16	4,547,574
\$100 million to \$500 million	93	25	20	1,957,981
\$10 million to \$100 million	372	94	14	2,566,203
\$1 million to \$10 million	815	139	3	216,158
< \$1 million	1,469	66	.4	5,588
Total	2,857	360	3,624	127,926,064

As shown in the table below, based on responses to Form BD, broker-dealers' most significant business lines include private placements of securities (61.4 of broker-dealers), retail sales of mutual funds (54.2), acting as a broker or dealer retailing corporate equity securities over the counter (51.2), acting as a broker or dealer retailing corporate debt securities (46.6), acting as a broker or dealer selling variable contracts, such as life insurance or annuities (39.5), acting as a broker of municipal debt/bonds or U.S. government securities (39.0 and 36.7, respectively), acting as an underwriter or selling group participant of corporate securities (30.0), investment advisory services (24.2), among others.<sup>398</sup>

TABLE 2—RETAIL BROKER-DEALER LINES OF BUSINESS AS OF DECEMBER 2017

Line of business	Total	
	Number of broker-dealers	Percent
Private Placements of Securities	1,755	61.4

<sup>393</sup> Total assets and customer accounts for broker-dealers that serve retail customers also include institutional accounts. Data available from Form BD and FOCUS data is not sufficiently granular to identify the percentage of retail and institutional accounts at firms.

<sup>394</sup> Of the 36 dual registrants in the group of retail broker-dealers with total assets in excess of \$500 million, total assets for these dual registrants are \$2.19 trillion (60%) of aggregate retail broker-dealer assets. Of the remaining 72 retail broker-dealers, 67 have affiliated investment advisers.

<sup>395</sup> The data is obtained from FOCUS filings as of December 2017. Note that there may be a double-counting of customer accounts among in particular the larger broker-dealers as they may report

introducing broker-dealer accounts as well in their role as clearing broker-dealers.

<sup>396</sup> In addition to the approximately 130 million individual accounts at broker-dealers, there are approximately 293,000 omnibus accounts (0.2% of total accounts at broker-dealers), with total assets of \$23.1 billion, across all 3,841 broker-dealers, of which approximately 99% are held at broker-dealers with greater than \$1 billion in total assets. See also *supra* note 388. Omnibus accounts reported in FOCUS data are the accounts of non-carrying broker-dealers with carrying broker-dealers. These accounts may have securities of multiple customers (of the non-carrying firm), or securities that are proprietary assets of the non-carrying broker-dealer. We are unable to determine, from the data available, how many customer

accounts non-carrying broker-dealers may have. The data does not allow the Commission to parse the total assets in those accounts to determine to whom such assets belong. Therefore, our estimate may be underinclusive of all customer accounts held at broker-dealers.

<sup>397</sup> "Customer Accounts" includes both broker-dealer and investment adviser accounts for dual registrants.

<sup>398</sup> Form BD requires applicants to identify the types of business engaged in (or to be engaged in) that accounts for 1% or more of the applicant's annual revenue from the securities or investment advisory business. Table 2 provides an overview of the types of businesses listed on Form BD, as well as the frequency of participation in those businesses by registered broker-dealers as of December 2017.

TABLE 2—RETAIL BROKER-DEALER LINES OF BUSINESS AS OF DECEMBER 2017—Continued

Line of business	Total	
	Number of broker-dealers	Percent
Mutual Fund Retailer .....	1,549	54.2
Broker or Dealer Retailing:		
Corporate Equity Securities OTC .....	1,462	51.2
Corporate Debt Securities .....	1,331	46.6
Variable Contracts .....	1,129	39.5
Municipal Debt/Bonds—Broker .....	1,115	39.0
U.S. Government Securities Broker .....	1,049	36.7
Put and Call Broker or Dealer or Options Writer .....	999	35.0
Underwriter or Selling Group Participant—Corporate Securities .....	857	30.0
Non-Exchange Member Arranging for Transactions in Listed Securities by Exchange Member .....	797	27.9
Investment Advisory Services .....	691	24.2
Broker or Dealer Selling Tax Shelters or Limited Partnerships—Primary Market .....	626	21.9
Trading Securities for Own Account .....	613	21.5
Municipal Debt/Bonds—Dealer .....	489	17.1
U.S. Government Securities—Dealer .....	347	12.1
Solicitor of Time Deposits in a Financial Institution .....	317	11.1
Underwriter—Mutual Funds .....	232	8.1
Broker or Dealer Selling Interests in Mortgages or Other Receivables .....	232	8.1
Broker or Dealer Selling Oil and Gas Interests .....	207	7.2
Broker or Dealer Making Inter-Dealer Markets in Corporate Securities OTC .....	205	7.2
Broker or Dealer Involved in Networking, Kiosk, or Similar Arrangements (Banks, Savings Banks, Credit Unions) .....	202	7.1
Internet and Online Trading Accounts .....	200	7.0
Exchange Member Engaged in Exchange Commission Business Other than Floor Activities .....	175	6.1
Broker or Dealer Selling Tax Shelters or Limited Partnerships—Secondary Market .....	163	5.7
Commodities .....	159	5.6
Executing Broker .....	111	3.9
Day Trading Accounts .....	92	3.2
Broker or Dealer Involved in Networking, Kiosk, or Similar Arrangements (Insurance Company or Agency) .....	90	3.2
Real Estate Syndicator .....	89	3.1
Broker or Dealer Selling Securities of Non-Profit Organizations .....	76	2.7
Exchange Member Engaged in Floor Activities .....	63	2.2
Broker or Dealer Selling Securities of Only One Issuer or Associate Issuers .....	47	1.6
Prime Broker .....	21	0.7
Crowdfunding FINRA Rule 4518(a) .....	18	0.6
Clearing Broker in a Prime Broker .....	14	0.5
Funding Portal .....	8	0.3
Crowdfunding FINRA Rule 4518(b) .....	3	0.1
Number of Retail-Facing Broker-Dealers .....	2,857	.....

b. Investment Advisers

Proposed Regulation Best Interest could affect, indirectly, other providers of investment advice, such as investment advisers, because the proposed rule could impact the competitive landscape in the market for the provision of financial advice.<sup>399</sup> This section first discusses Commission-registered investment advisers, followed by a discussion of state-registered investment advisers.

As of December 2017, there were 12,659 investment advisers registered with the Commission. The majority of Commission-registered investment advisers report that they provide

portfolio management services for individuals and small businesses.<sup>400</sup>

Of all SEC-registered investment advisers, 366 identified themselves as dually-registered broker-dealers.<sup>401</sup> Further, 2,478 investment advisers (20%) reported an affiliate that is a broker-dealer, including 1,916 investment advisers (15%) that reported an SEC-registered broker-dealer affiliate.<sup>402</sup> As shown in Panel A of Table 3 below, in aggregate, investment advisers have over \$72 trillion in assets under management (“AUM”). A

<sup>399</sup> In addition to the Commission-registered and state-registered investment advisers, which are the focus of this section, the proposed rule could also affect banks, trust companies, insurance companies, and other providers of investment advice.

<sup>400</sup> Of the 12,659 SEC-registered investment advisers, 7,979 (64%) report in Item 5.G.(2) of Form ADV that they provide portfolio management services for individuals and/or small businesses. In addition, there are approximately 17,800 state-registered investment advisers, of which 145 are also registered with the Commission. Approximately 13,800 state-registered investment advisers are retail facing (see Item 5.D. of Form ADV).

<sup>401</sup> See *supra* note 389.

<sup>402</sup> Form ADV Item 7.A.1.

substantial percentage of AUM at investment advisers is held by institutional clients, such as investment companies, pooled investment vehicles, and pension or profit-sharing plans; therefore, although the dollar value of AUM for investment advisers and of customer assets in broker-dealer accounts is comparable, the total number of accounts for investment advisers is only 27% of the number of customer accounts for broker-dealers.

Based on staff analysis of Form ADV data, approximately 60% of investment advisers (7,600) have some portion of their business dedicated to individual clients, including both high net worth and non-high net worth individual clients,<sup>403</sup> as shown in Panel B of Table

<sup>403</sup> We note that the data on individual clients obtained from Form ADV may not be exactly the same as who would be a “retail customer” as defined in proposed Regulation Best Interest because the data obtained from Form ADV is

3.<sup>404</sup> In total, these firms have approximately \$32 trillion of assets under management.<sup>405</sup> Approximately 6,600 registered investment advisers (52%) serve 29 million non-high net worth individual clients and have approximately \$5.33 trillion in assets under management, while nearly 7,400 registered investment advisers (58%) serve approximately 4.8 million high net worth individual clients with \$6.56 trillion in assets under management.<sup>406</sup>

TABLE 3, PANEL A—REGISTERED INVESTMENT ADVISERS (RIAs) AS OF DECEMBER 2017  
CUMULATIVE RIA ASSETS UNDER MANAGEMENT (AUM) AND ACCOUNTS

Size of investment adviser (AUM)	Number of RIAs	Number of dual-registered RIAs	Cumulative AUM (billion)	Cumulative number of accounts
> \$50 billion	246	15	\$48,221	17,392,968
\$1 billion to \$50 billion	3,238	115	21,766	11,560,805
\$500 million to \$1 billion	1,554	53	1,090	2,678,084
\$100 million to \$500 million	5,568	129	1,303	3,942,639
\$10 million to \$100 million	1,103	24	59	198,659
\$1 million to \$10 million	172	2	1	5,852
< \$1 million	778	28	.02	31,291
Total	12,659	366	72,439	35,810,298

TABLE 3, PANEL B—RETAIL REGISTERED INVESTMENT ADVISERS (RIAs) AS OF DECEMBER 2017  
CUMULATIVE RIA ASSETS UNDER MANAGEMENT (AUM) AND ACCOUNTS

Size of investment adviser (AUM)	Number of RIAs	Number of dual-registered RIAs	Cumulative AUM (billion)	Cumulative number of accounts
> \$50 billion	106	15	\$22,788	16,638,548
\$1 billion to \$50 billion	1,427	114	8,472	10,822,275
\$500 million to \$1 billion	934	52	652	2,602,220
\$100 million to \$500 million	4,114	126	917	3,814,900
\$10 million to \$100 million	711	24	40	231,663
\$1 million to \$10 million	98	1	.4	5,804
< \$1 million	198	29	.02	31,271
Total	7,588	361	32,870	34,146,681

As an alternative to registering with the Commission, smaller investment advisers could register with state regulators.<sup>407</sup> As of December 2017, there were 17,635 state registered investment advisers,<sup>408</sup> of which 145 are also registered with the Commission. Of the state-registered investment advisers, 236 are dually-registered as broker-dealers, while 5% (920) report a broker-dealer affiliate. In aggregate, state-registered investment advisers have

approximately \$341 billion in AUM. Eighty-two percent of state-registered investment advisers report that they provide portfolio management services for individuals and small businesses, compared to just 64% for Commission-registered investment advisers.

Approximately 77% of state-registered investment advisers (13,470) have some portion of their business dedicated to retail investors,<sup>409</sup> and in aggregate, these firms have

approximately \$308 billion in AUM.<sup>410</sup> Approximately 12,700 (72%) state-registered advisers serve 616,000 non-high net worth retail clients and have approximately \$125 billion in AUM, while over 11,000 (63%) state-registered advisers serve approximately 194,000 high net worth retail clients with \$138 billion in AUM.<sup>411</sup>

limited to individuals and does not involve any test of use for personal, family, or household purposes.

<sup>404</sup> We use the responses to Items 5(D)(a)(1), 5(D)(a)(3), 5(D)(b)(1), and 5(D)(b)(3) of Part 1A of Form ADV. If at least one of these responses was filled out as greater than 0, the firm is considered as providing business to retail investors. Form ADV Part 1A.

<sup>405</sup> The aggregate AUM reported for these investment advisers that have retail investors includes both retail AUM as well as any institutional AUM also held at these advisers.

<sup>406</sup> Estimates are based on IARD system data as of December 31, 2017. The AUM reported here is specifically that of non-high net worth individual clients. Of the 7,600 investment advisers serving individual clients, 360 are also registered as broker-dealers.

<sup>407</sup> Pursuant to the Dodd-Frank Act, Item 2.A. of Part 1A of Form ADV requires an investment

adviser to register with the SEC if it (i) is a large adviser that has \$100 million or more of regulatory assets under management (or \$90 million or more if an adviser is filing its most recent annual updating amendment and is already registered with the SEC); (ii) is a mid-sized adviser that does not meet the criteria for state registration or is not subject to examination; (iii) meets the requirements for one or more of the revised exemptive rules under section 203A discussed below; (iv) is an adviser (or subadviser) to a registered investment company; (v) is an adviser to a business development company and has at least \$25 million of regulatory assets under management; or (vi) received an order permitting the adviser to register with the Commission. Although the statutory threshold is \$100 million, the SEC raised the threshold to \$110 million for those investment advisers that do not already file with the SEC.

<sup>408</sup> There are 79 investment advisers with latest reported Regulatory Assets Under Management in

excess of \$110 million but are not listed as registered with the SEC. For the purposes of this rulemaking, these are considered erroneous submissions.

<sup>409</sup> We use the responses to Items 5.D.(a)(1), 5.D.(a)(3), 5.D.(b)(1), and 5.D.(b)(3) of Part 1A of Form ADV. If at least one of these responses was filled out as greater than 0, the firm is considered as providing business to retail investors. Form ADV Part 1A.

<sup>410</sup> The aggregate AUM reported for these investment advisers that have retail investors includes both retail AUM as well as any institutional AUM also held at these advisers.

<sup>411</sup> Estimates are based on IARD system data as of December 31, 2017. The AUM reported here is specifically that of non-high net worth investors. Of the 13,471 investment advisers serving retail investors, 144 may also be dually-registered as broker-dealers.

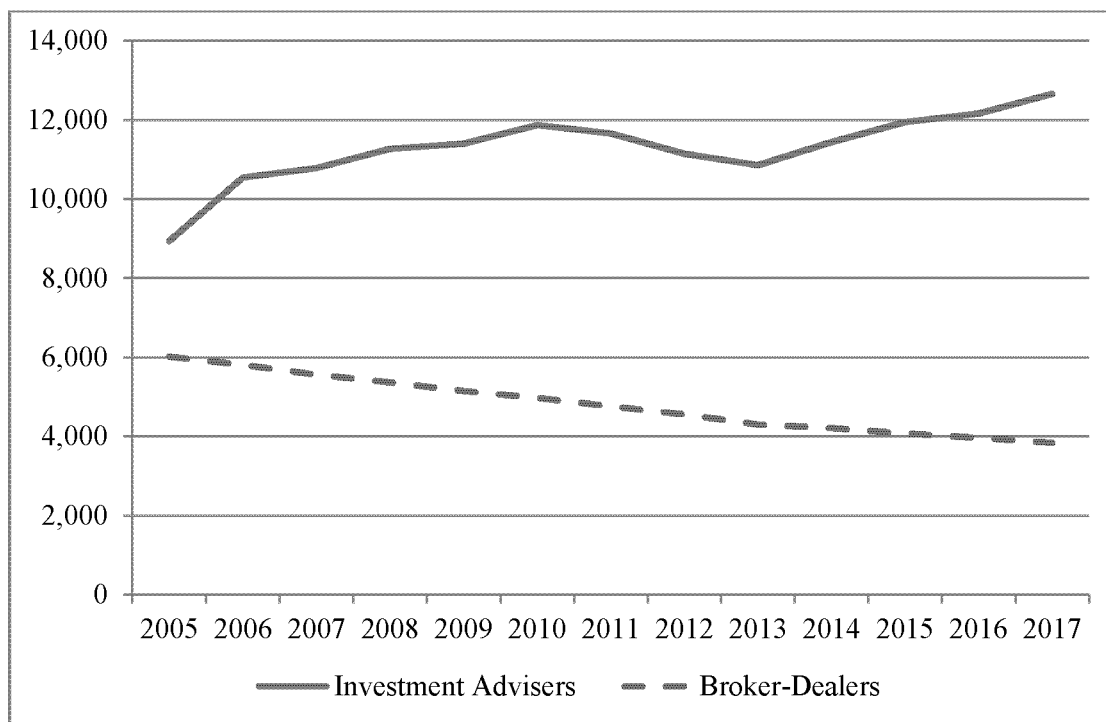
c. Trends in the Relative Numbers of Providers of Financial Services

Over time, the relative numbers of broker-dealers and Commission-registered investment advisers have changed. Figure 1 presented below shows the time series trend in the relative numbers of broker-dealers and

Commission-registered investment advisers between 2005 and 2017. Over the last 13 years, the number of broker-dealers has declined from over 6,000 in 2005 to less than 4,000 in 2017, while the number of investment advisers has increased from approximately 9,000 in 2005 to over 12,000 in 2017. This

change in the relative numbers of broker-dealers and investment advisers over time likely affects the competition for advice and potentially reduces the choices available to retail customers on how to receive or pay for such advice, the nature of the advice, and the attendant conflicts of interest.

**Figure 1: Time Series of the Numbers of Investment Advisers and Broker-Dealers (2005 – 2017)**



Increases in the number of investment advisers and decreases in the number of broker-dealers could have occurred for a number of reasons, including anticipation of possible regulatory changes to the industry, other regulatory restrictions, technological innovation (*i.e.*, robo-advisers and online trading platforms), product proliferations (*e.g.*, index mutual funds and exchange-traded products), and industry consolidation driven by economic and market conditions, particularly among broker-dealers.<sup>412</sup> Commission staff has

<sup>412</sup> See Hester Peirce, "Dwindling numbers in the financial industry," Brookings Center on Markets and Regulation, May 15, 2017 ("Brookings Report"), available at <https://www.brookings.edu/research/dwindling-numbers-in-the-financial-industry/> (noting that "SEC restrictions have increased by almost thirty percent [since 2000]," and that regulations post-2010 were driven in large part by the Dodd-Frank Act). Further, the Brookings Report observation of increased regulatory restrictions on broker-dealers only reflects CFTC or SEC regulatory actions, but does not include regulation by FINRA, NFA, the MSRB, or other SROs.

observed the transition by broker-dealers from traditional brokerage services to providing also investment advisory services (often under an investment adviser registration, whether federal or state), and many firms have been more focused on offering fee-based accounts than accounts that charge commissions.<sup>413</sup> Broker-dealers have

<sup>413</sup> The Brookings Report also discusses the shift from broker-dealer to investment advisory business models for retail investors, in part due to the Department of Labor's fiduciary rule (page 7). See also the RAND Study, *supra* note 28, which documents a shift from transaction-based to fee-based accounts prior to recent regulatory changes. Declining transaction-based revenue due to declining commission rates and competition from discount brokerage firms has made offering fee-based products and services more attractive. Although discount brokerage firms generally provide execution-only services and do not compete directly in the advice market with full service broker-dealers and investment advisers, entry by discount brokers has contributed to lower commission rates throughout the broker-dealer industry. Further, fee-based activity generates a

indicated that the following factors have contributed to this migration: Provision of stability or increase in profitability,<sup>414</sup> perceived lower

steady stream of revenue regardless of the customer trading activity, unlike commission-based accounts.

<sup>414</sup> Commission staff examined a sample of recent Form 10-K or Form 10-Q filings of large broker-dealers, many of which are dually-registered as investment advisers, that have a large fraction of retail customer accounts to identify relevant broker-dealers. See, *e.g.*, Edward Jones 9/30/2017 Form 10-Q, available at [https://www.sec.gov/Archives/edgar/data/815917/000156459017023050/ck0000815917-10q\\_20170929.htm](https://www.sec.gov/Archives/edgar/data/815917/000156459017023050/ck0000815917-10q_20170929.htm); Raymond James 9/30/2017 Form 10-K, available at <https://www.sec.gov/Archives/edgar/data/720005/000072000517000089/rjf-20170930x10k.htm>; Stifel 12/31/2016 Form 10-K, available at [https://www.sec.gov/Archives/edgar/data/720672/000156459017022758/sf-10q\\_20170930.htm](https://www.sec.gov/Archives/edgar/data/720672/000156459017022758/sf-10q_20170930.htm); Wells Fargo 9/30/2017 10-Q, available at <https://www.sec.gov/Archives/edgar/data/72971/000007297117000466/wfc-09302017x10q.htm>; and Ameriprise 12/31/2016 Form 10-K, available at <https://www.sec.gov/Archives/edgar/data/820027/000082002717000007/ameriprisefinancial12312016.htm>. We note that discussions in Form 10-K and 10-Q filings of this sample of broker-dealers may not be representative of other large broker-dealers or of small to mid-size

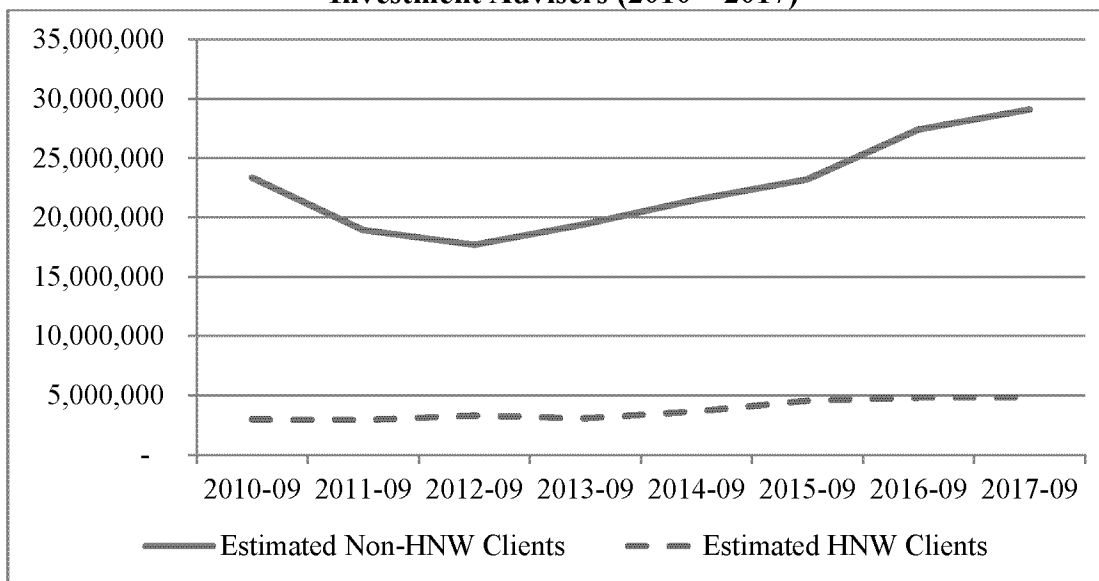
regulatory burden, and provisions of more or better services to retail customers.

Further, there has been a substantial increase in the number of retail clients at investment advisers, both high net worth clients and non-high net worth

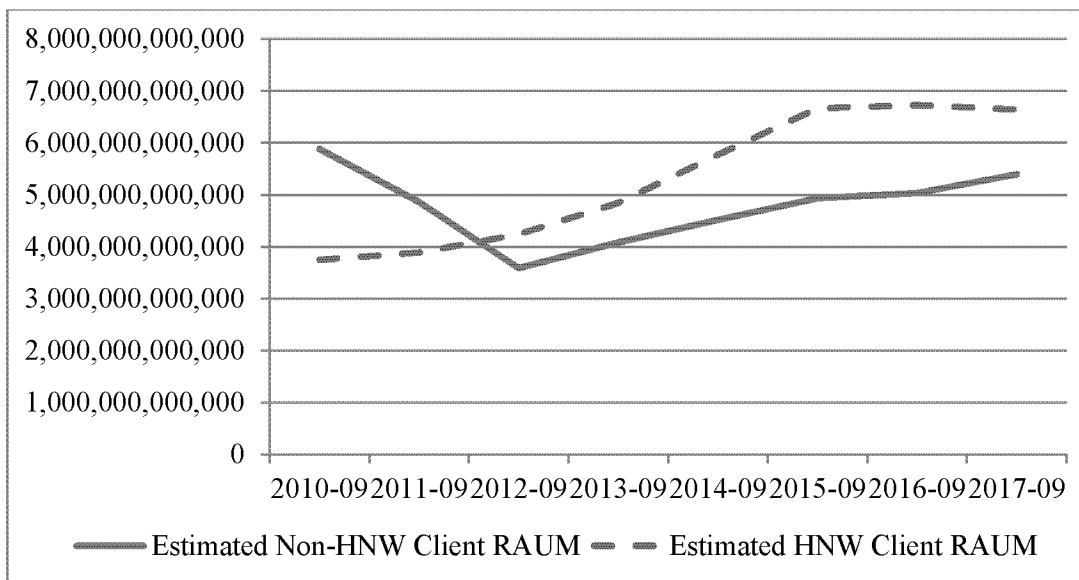
clients, as shown in Figure 2. Although the number of non-high net worth retail customers of investment advisers dipped between 2010 and 2012, since 2012, more than 12 million new non-high net worth retail clients have been added. With respect to assets under

management, we observe a similar, albeit more pronounced pattern for non-high net worth retail clients as shown in Figure 3. For high net worth retail clients, there has been a pronounced increase in AUM since 2012, although AUM has leveled off since 2015.

**Figure 2: Time Series of the Number of Retail Clients of Investment Advisers (2010 – 2017)**



**Figure 3: Time Series of the Retail Clients of Investment Advisers Assets under Management (2010 – 2017)**



broker-dealers. Some firms have also reported record profits as a result of moving clients into fee-based accounts, and cite that it provides “stability and high returns.” See “Morgan Stanley Wealth Management fees climb to all-time high,” Bloomberg, Jan. 18, 2018, available at <https://www.bloomberg.com/news/articles/2018-01-18/morgan-stanley-wealth-management-fees-hit>

*record-on-stock-rally*. Morgan Stanley increased the percentage of client assets in fee-based accounts from 37% in 2013 to 44% in 2017, while decreasing the dependence on transaction-based revenues from 30% to 19% over the same time period (Morgan Stanley Strategic Update, Jan. 18, 2018, available at <https://www.morganstanley.com/about-us-ir/shareholder/4q2017-strategic-update.pdf>). See also

Beilfuss, Lisa and Brian Hershberg, “WSJ Wealth Adviser Briefing: The Reinvention of Morgan and Merrill, Adviser Profile,” The Wall Street Journal, Jan. 25, 2018, available at <https://blogs.wsj.com/moneybeat/2018/01/25/wsj-wealth-adviser-briefing-the-reinvention-of-morgan-and-merrill-adviser-profile/>.



d. Registered Representatives of Broker-Dealers, Investment Advisers, and Dually-Registered Firms

We estimate the number of associated natural persons of broker-dealers through data obtained from Form U4, which generally is filed for individuals who are engaged in the securities or investment banking business of a broker-dealer that is a member of an SRO (“registered representatives” or “RR”s).<sup>415</sup> Similarly, we approximate the number of supervised persons of registered investment advisers through the number of registered investment adviser representatives (or “registered IARs”), who are supervised persons of

investment advisers who meet the definition of investment adviser representatives in Advisers Act Rule 203A–3 and are registered with one or more state securities authorities to solicit or communicate with clients.<sup>416</sup>

We estimate the number of registered representatives and registered IARs (together “dually-registered representatives”) at broker-dealers, investment advisers, and dual-registrants by considering only the employees of those firms that have Series 6 or Series 7 licenses or are registered with a state as a broker-dealer agent or investment adviser representative.<sup>417</sup> We consider only employees at firms who have retail-

facing business, as defined previously.<sup>418</sup> We observe in Table 5 that approximately 61% of registered financial professionals are employed by dually-registered entities. The percentage varies by the size of the firm. For example, for firms with total assets between \$1 billion and \$50 billion, 72% of all registered financial professionals in that size category are employed by dually-registered firms. Focusing on dually-registered firms only, approximately 59.7% of total licensed representatives at these firms are dually-registered, approximately 39.9% are only registered representatives; and less than 1% are only registered investment adviser representatives.

TABLE 5—TOTAL LICENSED REPRESENTATIVES AT BROKER-DEALERS, INVESTMENT ADVISERS, AND DUALLY-REGISTERED FIRMS WITH RETAIL CUSTOMERS <sup>419</sup>

Size of firm (total assets for standalone BDs and dually-registered firms; AUM for standalone IAs)	Total number of representatives	Percentage of representatives in dually-registered firms	Percentage of representatives in standalone BD	Percentage of representatives in standalone IA
>\$50 billion .....	82,668	75	8	18
\$1 billion to \$50 billion .....	150,662	72	10	18
\$500 million to \$1 billion .....	31,673	67	16	16
\$100 million to \$500 million .....	62,539	58	24	18
\$10 million to \$100 million .....	116,047	52	47	1
\$1 million to \$10 million .....	37,247	34	63	2
<\$1 million .....	13,563	7	87	6
Total Licensed Representatives .....	494,399	61	27	12

In Table 6 below, we estimate the number of employees who are registered representatives, investment adviser representatives, or dually-registered representatives.<sup>420</sup> Similar to Table 5, we calculate these numbers using Form U4 filings. Here, we also limit the sample to employees at firms that have

retail-facing businesses as discussed previously.<sup>421</sup>

In Table 6, approximately 24% of registered employees at registered broker-dealers or investment advisers are dually-registered representatives. However, this proportion varies significantly across size buckets. For

example, for firms with total assets between \$1 billion and \$50 billion,<sup>422</sup> approximately 36% of all registered employees are dually-registered representatives. In contrast, for firms with total assets below \$1 million, 15% of all employees are dual-hatted representatives.

<sup>415</sup> The number of associated natural persons of broker-dealers may be different from the number of registered representatives of broker-dealers, because clerical/ministerial employees of broker-dealers are associated persons, but are not required to register. Therefore, using the registered representative number does not include such persons. However, we do not have data on the number of associated natural persons and therefore are not able to provide an estimate of the number of associated natural persons. We believe that the number of registered representatives is an appropriate approximation because they are the individuals at broker-dealers that provide advice and services to customers.

<sup>416</sup> See Advisers Act Rule 203A–3. However, we note that the data on numbers of registered IARs may undercount the number of supervised persons of investment advisers who provide investment advice to retail investors because not all supervised persons who provide investment advice on behalf of an investment adviser are required to register as IARs. For example, Commission rules exempt from IAR registration supervised persons who provide advice only to non-individual clients or to individuals who meet the definition of “qualified client,” all of which individuals would fall under the definition of retail investor if they use the assets

in advisory accounts for personal, family, or household purposes. See *id.* In addition, state securities authorities may impose additional criteria for requiring registration as an IAR.

<sup>417</sup> We calculate these numbers based on Form U4 filings. Broker-dealers, investment advisers, and issuers of securities must file this form when applying to register persons in certain jurisdictions and with certain SROs. Such firms and representatives generally have an obligation to amend and update information as changes occur. Using the examination information contained in the form, we consider an employee a financial professional if he has an approved, pending, or temporary registration status for either Series 6 or 7 (RR) or is registered as an investment adviser representative in any state or U.S. territory (IAR), although there are representatives that have passed exams other than the Series 7. We limit the firms to only those that do business with retail investors.

<sup>418</sup> See *supra* notes 392 and 404.

<sup>419</sup> The classification of firms as dually-registered, standalone broker-dealers, and standalone investment advisers comes from Forms BD, FOCUS, and ADV as described earlier. The number of representatives at each firm is obtained from Form U4 filings. Note that all percentages in the table

have been rounded to the nearest whole percentage point.

<sup>420</sup> We calculated these numbers based on Form U4 filings.

<sup>421</sup> See *supra* notes 392 and 404.

<sup>422</sup> Firm size is measured by total firm assets from the balance sheet (source: FOCUS reports) for broker-dealers and dual registrants, and by assets under management for investment advisers (source: Form ADV). We are unable to obtain customer assets for broker-dealers, and for investment advisers, we can only obtain information from Form ADV as to whether the firm assets exceed \$1 billion. We recognize that our approach of using firm assets for broker-dealers and customer assets for investment advisers does not allow for direct comparison; however, our objective is to provide measures of firm size and not to make comparisons between broker-dealers and investment advisers based on firm size. Across both broker-dealers and investment advisers, larger firms, regardless of whether we stratify on firm total assets or assets under management, have more customer accounts, are more likely to be dually-registered, and have more representatives or employees per firm, than smaller broker-dealers or investment advisers.

TABLE 6—NUMBER OF EMPLOYEES AT RETAIL-FACING FIRMS WHO ARE REGISTERED REPRESENTATIVES, INVESTMENT ADVISER REPRESENTATIVES, OR BOTH<sup>423</sup>

Size of firm (total assets for standalone BDs and dually-registered firms; AUM for standalone IAs)	Total number of employees	Percentage of dual-hatted representatives	Percentage of RRs only	Percentages of IARs only
>\$50 billion .....	216,655	18	17	1
\$1 billion to \$50 billion .....	292,663	36	11	3
\$500 million to \$1 billion .....	50,531	15	40	6
\$100 million to \$500 million .....	112,119	23	24	8
\$10 million to \$100 million .....	189,318	19	41	1
\$1 million to \$10 million .....	61,310	19	39	1
< \$1 million .....	19,619	15	46	3
Total Employees at Retail-Facing Firms .....	942,215	24	24	3

Approximately 88% of investment adviser representatives in Table 5 are dually-registered as registered representatives. This percentage is relatively unchanged from 2010. According to information provided in a FINRA comment letter in connection with the 913 Study, 87.6% of registered investment adviser representatives were dually-registered as registered representatives as of mid-October 2010.<sup>424</sup> In contrast, approximately 50% of registered representatives were dually-registered as investment adviser representatives at the end of 2017.<sup>425</sup>

#### e. Financial Incentives of Firms and Financial Professionals

Commission experience indicates that there is a broad range of financial incentives provided by standalone broker-dealers and dually-registered firms to their representatives.<sup>426</sup> While some firms provided a base pay for their financial professionals ranging from approximately \$45,000 to \$85,000 per

<sup>423</sup> See *supra* notes 391, 403, 420, and 422. Note that all percentages in the table have been rounded to the nearest whole percentage point.

<sup>424</sup> FINRA comment letter to File Number 4-606; Obligations of Brokers, Dealers and Investment Advisers (Nov. 3, 2010), available at <https://www.sec.gov/comments/4-606/4606-2836.pdf>.

<sup>425</sup> In order to obtain the percentage of IARs that are dually-registered as registered representatives of broker-dealers, we sum the representatives at dually-registered entities and those at investment advisers, across size categories to obtain the aggregate number of representatives in each of the two categories. We then divide the aggregate dually-registered representatives by the sum of the dually-registered representatives and the IARs at investment adviser-only firms. We perform a similar calculation to obtain the percentage of registered representatives of broker-dealers that are dually-registered as IARs.

<sup>426</sup> Information on compensation and financial incentives generally relates to 2016 compensation arrangements for a sample of approximately 20 firms, comprised of both standalone broker-dealers and dually-registered firms. We acknowledge that the information provided in this baseline may not be representative of the compensation structures more generally because of the diversity and complexity of services and products offered by standalone broker-dealers and dually-registered firms.

year, many firms provided compensation only through a percentage of commissions, plus performance-based awards, such as individual or team bonus based on production.

Commission-based payouts to financial professionals ranged from 30% to 95%, although these payouts were generally reduced by various costs and expenses attributable to the financial professional (e.g., clearing costs associated with some securities, SRO or SIPC-related charges, and insurance, among others).

Several firms had varying commission payout rates depending on the product type being sold. For example, payouts ranged from 76.5% for stocks, bonds, options, and commodities to 90% for open-ended mutual funds, private placements, and unit investment trusts. Several firms charged varying commissions on products depending on the amount of product sold (e.g., rates on certain proprietary mutual funds ranged from 0.75% to 5.75% depending on the share class), but did not provide those payout rates to financial professionals based on product type. Some firms also provided incentives for their financial professionals to recommend proprietary products and services over third-party or non-proprietary products. Commission rates for some firms, however, declined as the dollar amount sold increased and such rates varied across asset classes as well (e.g., within a given share class, rates ranged from 1.50% to 5.75% depending on the dollar amount of the fund sold). With respect to compensation to individual financial professionals, if payout rates for mutual funds were approximately 90% (as discussed above, for example), financial professionals could earn between 0.68% and 5.18%, depending on the type and amount of product sold.

For financial professionals who did not earn commission-based compensation, some firms charged retail customers flat fees ranging from \$500 to

\$2,500, depending on the level of service required, such as financial planning, while others charged hourly rates ranging from \$150 to \$350 per hour. For dually-registered firms that charged clients based on a percentage of assets under management, the average percentage charged varied based on the size of the account: The larger the assets under management, the lower the percentage fee charged. Percentage-based fees for the sample firms ranged from approximately 1.5% for accounts below \$250,000 to 0.5% for accounts in excess of \$1 million.<sup>427</sup> If payout rates range between 30% and 95%, a firm charging a customer \$500 could provide compensation to the financial professional between \$150 and \$475 for each financial plan provided. For fee-based accounts, assuming that a retail customer had an account worth \$250,000, the firm would charge fees of \$3,750 ( $\$250,000 \times 1.5\%$ ), and the financial professional could earn between \$1,170 and \$3,560 annually for each account.

In addition to “base” compensation, most firms also provided bonuses (based on either individual or team performance) or variable compensation, ranging from approximately 10% to

<sup>427</sup> We note that some firms could have higher or lower commission payout rates or asset-based fee percentages than those provided here. For example, based on a review of Form ADV Part 2A (the brochure) of several large dual registrants (not included in the sample above), asset-based fees for low AUM accounts could range as high as 2.0% to 3.0%, with the average fee for high AUM accounts ranging between 0.5% to 1.5%. See also “Average Financial Advisor Fees & Costs, 2017 Report, Understanding Advisory & Investment Management Fees,” AdvisoryHQ, available at <http://www.advisoryhq.com/articles/financial-advisor-fees-wealth-managers-planners-and-fee-only-advisors/>. The AdvisoryHQ report shows that average asset-based fees range from 1.18% for accounts less than \$50,000 to less than 0.60% for accounts in excess of \$30 million, while fixed-fees range from \$7,500 for accounts less than \$500,000 to \$55,000 for accounts in excess of \$7.5 million. Again, we note that these are charges to clients and are not indicative of the total compensation earned by the financial professional per account.

83% of base compensation. While the majority of firms based at least some portion of their bonuses on production, usually in the form of total gross revenue, other forms of bonus compensation were derived from customer retention, customer experience, and manager assessment of performance. Moreover, some firms used a tiered system within their compensation grids depending on firm experience and production levels. Financial professionals' variable compensation could also increase when they enrolled retail customers in advisory accounts versus other types of accounts, such as brokerage accounts. Some firms also provided transition bonuses for financial professionals with prior work experience based on historical trailing production levels and AUM. Although many firms did not provide any incentive-based contests or programs, some firms awarded non-cash incentives for meeting certain performance, best practices, or customer service goals, including trophies, dinners with senior officers, and travel to annual meetings with other award winners.

## 2. Regulatory Baseline

Regulation Best Interest would require broker-dealers and natural persons associated with broker-dealers, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, to 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, or natural person who is an associated person of the broker or dealer making the recommendation, ahead of the interest of the retail customer. Regulation Best Interest incorporates and goes beyond the existing broker-dealer regulatory regime for advice. In this section, we describe the existing regulatory baseline for broker-dealers, including existing obligations under the federal securities laws and FINRA rules, in particular those related to the suitability of recommendations and disclosure of conflicts of interest, state regulation, existing antifraud provisions, and state laws that impose fiduciary obligations, and other obligations that would be imposed by the DOL Fiduciary Rule and related PTEs, most notably the BIC Exemption.

### a. Suitability Obligations

Under the antifraud provisions of the federal securities laws and SRO rules, broker-dealers are required to deal fairly with their customers. By virtue of

engaging in the brokerage profession, a broker-dealer makes an implicit representation to those persons with whom it transacts business that it will deal fairly with them, consistent with the standards of the profession.<sup>428</sup> A central aspect of a broker-dealer's duty of fair dealing is the suitability obligation, which has been interpreted as requiring a broker-dealer to make recommendations that are consistent with the best interest of his customer under SRO rules.<sup>429</sup> The concept of suitability has been interpreted as an obligation under the antifraud provisions of the federal securities laws and also under specific SRO rules.<sup>430</sup> FINRA Rule 2111 ("Suitability") requires that a broker-dealer or associated person have a reasonable basis to believe that a recommendation or investment strategy is "suitable" for the retail customer.<sup>431</sup> The suitability obligation is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of commercial conduct.<sup>432</sup>

Under FINRA Rule 2111, there are three primary suitability requirements for broker-dealers and associated persons. First, reasonable-basis suitability requires that, based on reasonable diligence, a broker-dealer must have a reasonable basis that a recommendation is suitable for at least some retail customers.<sup>433</sup> Second, customer-specific suitability requires that, based on a given customer's investment profile as detailed above, the broker-dealer has a reasonable basis to believe that the recommendation or investment strategy is suitable for that customer.<sup>434</sup> Finally, quantitative suitability requires that a broker-dealer must have a reasonable basis to believe that a series of recommended transactions is not excessive or unsuitable for a customer when taken together in light of the customer's investment profile, even if each individual recommendation is suitable in isolation.<sup>435</sup> Broker-dealers also have additional specific suitability

<sup>428</sup> See 913 Study at 51; see also *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).

<sup>429</sup> See, e.g., *In re Application of Raghavan Sathianathan*, Exchange Act Release No. 54722 at 21 (Nov. 8, 2006). See also *supra* note 15.

<sup>430</sup> See *Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969).

<sup>431</sup> See FINRA Rule 2111.

<sup>432</sup> See FINRA Rule 2111.01.

<sup>433</sup> According to FINRA Rule 2111, reasonable diligence requires that the broker-dealer or the associated person understands the potential risks and rewards of the recommendation or the investment strategy.

<sup>434</sup> *Id.*

<sup>435</sup> *Id.*

obligations with respect to certain types of products or transactions, such as variable insurance products and non-traditional products, including structured products and leveraged and exchange-traded funds.<sup>436</sup>

### b. Existing Broker-Dealer Disclosure Obligations

As described above, broker-dealers are subject to a number of specific disclosure obligations when they effect certain customer transactions, and are subject to additional disclosure obligations under the antifraud provisions of the federal securities laws.<sup>437</sup> Generally, under the antifraud provisions of the federal securities laws, a broker-dealer's duty to disclose material information to its customers depends on the scope of the relationship with the customer, which is fact intensive.<sup>438</sup> When making recommendations, broker-dealers may be held liable if they do not provide honest and complete information or do not disclose material conflicts of interest of which they are aware.<sup>439</sup> For example, in making recommendations, courts have found broker-dealers should have disclosed that they were: acting as a market maker for the recommended security; trading as a principal with respect to the recommended security; engaging in revenue sharing with a recommended mutual fund; or "scalping" a recommended security.<sup>440</sup>

In addition to the antifraud provisions of the federal securities laws, courts interpreting state common law have imposed fiduciary obligations on broker-dealers in certain circumstances. Generally, courts have found that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, owe customers a fiduciary duty.<sup>441</sup> As discussed above, in developing proposed Regulation Best Interest, the Commission has drawn from state common law fiduciary principles, among other things, in order to establish greater consistency in the level of retail customer protections and to ease compliance with Regulation Best Interest where other legal regimes—such as state common law—might also apply. For instance, under proposed Regulation Best Interest, a broker-

<sup>436</sup> See, e.g., FINRA Rule 2330, "Members' Responsibilities Regarding Deferred Variable Annuities;" FINRA Rule 2370, "Securities Futures;" see also 913 Study at 65–66.

<sup>437</sup> See *supra* notes 175–177 and 205 and accompanying text.

<sup>438</sup> See *supra* note 176.

<sup>439</sup> *Id.*

<sup>440</sup> See 913 Study at notes 251–54.

<sup>441</sup> See *supra* note 15.

dealer's duty to exercise reasonable diligence, care, skill, and prudence would resemble the standard of conduct that has been imposed on broker-dealers found to be acting in a fiduciary capacity under state common law.<sup>442</sup> Similarly, a broker-dealer's Disclosure Obligation (along with the Conflict of Interest Obligations) under proposed Regulation Best Interest would resemble the duty to disclose material conflicts imposed on broker-dealers found to be acting as fiduciaries under state common law.<sup>443</sup>

### c. Department of Labor's Fiduciary Rule and Related Federal Securities Laws

DOL amendments to its regulation defining investment advice in the DOL Fiduciary Rule would broadly expand the types of broker-dealer services that may trigger fiduciary status for the purposes of the prohibited transaction provisions of ERISA and the Code as a result of rendering investment advice to retirement accounts.<sup>444</sup> As noted, in connection with the DOL Fiduciary Rule, DOL amended certain existing PTEs and adopted new PTEs, including in particular the BIC Exemption, which generally permits certain financial institutions including broker-dealers to recommend investment transactions and receive commissions and other compensation resulting from the recommended transactions under certain conditions.<sup>445</sup> As discussed

above, a broker-dealer that wishes to rely on the BIC Exemption to engage in transactions that would otherwise be prohibited (*e.g.*, providing investment recommendations and receiving "conflicted compensation")—would have to adhere to the Impartial Conduct Standards (including obligations to provide "best interest" recommendations, receive no more than reasonable compensation, and avoid making statements that are materially misleading at the time they are made). Broker-dealers that seek to rely on the BIC Exemption would have to satisfy additional conditions including (among other things) that, as described above, require broker-dealers to (1) enter into a written contract with each IRA owner enforceable against the broker-dealer that acknowledges fiduciary status, commits to adhere to the Impartial Conduct Standards, and warrants to the adoption of certain policies and procedures, (2) implement policies and procedures reasonably designed to ensure that the firm and its advisers provide best interest advice and minimize the harmful impact of conflicts of interest in conflicts, including a prohibition against differential compensation or other incentives that were intended or expected to cause advisers to provide recommendations that are not in the customer's best interest, and (3) disclose information about fees, compensation and material conflicts of interest associated with recommendations in initial and ongoing disclosures, including website disclosures.<sup>446</sup>

Existing broker-dealer obligations under the federal securities laws and FINRA rules prohibit misleading statements and require fair and reasonable compensation. The antifraud provisions of the federal securities laws prohibit broker-dealers from making misleading statements,<sup>447</sup> while FINRA Rule 2210 specifically addresses communications between broker-dealers and the public and requires that these communications be based on principles of fair dealing and good faith and be fair and balanced.<sup>448</sup> Under FINRA rules, prices for securities and broker-dealer compensation are required to be fair and reasonable, taking into consideration all relevant circumstances.<sup>449</sup> Although the

existing standards and rules identified above prohibit broker-dealers from making misleading statements, address their communications with the public, and require fair and reasonable compensation, the DOL also adopted the Impartial Conduct Standards to address these issues in the BIC Exemption.<sup>450</sup>

As discussed above, as a practical matter, broker-dealers offering IRA brokerage accounts would generally need to meet the conditions of the BIC Exemption or one of the related PTEs to make recommendations to brokerage customers with such accounts and receive commissions or other compensation relating to recommended transactions. To determine the universe of broker-dealers that offer IRA brokerage accounts and generally would need to meet the conditions of the BIC Exemption for purposes of this baseline, we assume that all broker-dealers that have retail accounts are required to comply with the PTEs, including the BIC Exemption, in providing services to at least some of their retail accounts. The Commission does not currently have data on the number of firms that would rely on these PTEs and that would be required to provide these disclosures.<sup>451</sup> However, the Commission can broadly estimate the maximum number of broker-dealers that would be subject to the requirements of the PTEs from the number of broker-dealers that have retail customer accounts. Approximately 74.4% (2,857) of registered broker-dealers report sales to retail customers.<sup>452</sup> Similarly, approximately 7,600 (60% of) investment advisers serve high net worth and non-high net worth individual clients. The Commission understands that these numbers are an upper bound and likely overestimates the broker-dealers and investment advisers that provide retirement account services.<sup>453</sup>

Commissions"), 2122 ("Charges for Services Performed"), and 2341 ("Investment Company Securities").

<sup>450</sup> See BIC Exemption Release, 81 FR 21007, 21030–32.

<sup>451</sup> In order to perform this analysis, the Commission would need to know which financial firms have retirement-based assets as part of their business model. Under the current reporting regimes for both broker-dealers and investment advisers, they are not required to disclose whether (or what fraction of) their accounts are held by retail investors in retirement-based accounts.

<sup>452</sup> As of December 2017, 3,841 broker-dealers filed Form BD. Retail sales by broker-dealers were obtained from Form BR. See *supra* note 392.

<sup>453</sup> The Department of Labor Regulatory Impact Analysis ("DOL RIA") identified approximately 4,000 broker-dealers (FINRA, 2016), of which approximately 2,500 are estimated to have either ERISA accounts or IRA associated with the broker-dealers, similar to the estimates that we provide

<sup>442</sup> See, *e.g.*, *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1215 (8th Cir. 1990) (finding that the district court did not abuse its discretion in instructing the jury that licensed securities brokers were fiduciaries that owed their customers a duty of utmost good faith, integrity, and loyalty).

<sup>443</sup> See, *e.g.*, *United States v. Szur*, 289 F.3d 200, 212 (2d Cir. 2002) (broker's fiduciary relationship with customer gave rise to a duty to disclose commissions to customer, which would have been relevant to customer's decision to purchase stock); *Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948) (Commission Opinion), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969, 976 (D.C. Cir. 1949) (broker-dealer acted in the capacity of a fiduciary and, as such, broker-dealer was under a duty to make full disclosure of the nature and extent of her adverse interest, "including her cost of the securities and the best price at which the security might be purchased in the open market").

<sup>444</sup> See BIC Exemption Release, 81 FR at 21007 (DOL states that it "anticipates that the [DOL Fiduciary Rule] will cover many investment professionals who did not previously consider themselves to be fiduciaries under ERISA or the Code.").

<sup>445</sup> See BIC Exemption Release. Broker-dealers and their registered representatives are not, however, required to comply with conditions under the BIC Exemption if they adopt a different approach to avoid non-exempt prohibited transactions, including by meeting the conditions of the statutory exemption for the provision of investment advice to participants of individual account plans under ERISA sections 408(b)(14) and 408(g), or by offsetting third-party payments against

level fees, see BIC Exemption Release, 81 FR at 21013, at n. 23 and accompanying text.

<sup>446</sup> See BIC Exemption Release, 81 FR at 21007. These conditions are discussed in more detail below.

<sup>447</sup> See Exchange Act Sections 10(b) and 15(c).

<sup>448</sup> See FINRA Rule 2210 ("Communications with the Public").

<sup>449</sup> See *e.g.*, Exchange Act Sections 10(b) and 15(c); FINRA Rules 2121 ("Fair Prices and

A recent survey and study were conducted to provide information about how the broker-dealer industry has begun to transition as a result of the DOL Fiduciary Rule. In 2017, the Securities Industry and Financial Markets Association (“SIFMA”) teamed with Deloitte and conducted a study focusing on the impact of the DOL Fiduciary Rule on retirement investors and financial institutions.<sup>454</sup> The SIFMA Study surveyed 21 SIFMA members and captured 43% of U.S. “financial advisors” (132,000 out of 310,000), 35 million retail retirement accounts,<sup>455</sup> and 27% of qualified retirement savings assets (\$4.6 trillion out of \$16.9 trillion).

Of the 21 SIFMA members that participated in the survey, 53% eliminated or reduced access to brokerage advice services and 67% have migrated away from open choice to fee-based or limited brokerage services. For those retail customers faced with eliminated or reduced brokerage advice services, 63% chose to move to self-directed accounts rather than fee-based accounts and cited the reasons as “not wanting to move to a fee-based model, not in the best interest to move to a fee-based model, did not meet account minimums, or wanted to maintain positions in certain asset classes prohibited by the fee-based models.” For those retail customers that migrated from brokerage to fee-based models, the average change in all-in fees increased by 141% from 46 basis points (bps) to 110 bps.

Further, 95% of survey participants altered their product offerings, by reducing or eliminating certain asset or share classes. For example, 86% of the respondents reduced the number or type of mutual funds (e.g., 29% eliminated

no-load funds, while 67% reduced the number of mutual funds), and 48% reduced annuity product offerings. Moreover, although the DOL Fiduciary Rule applies only in connection with services for retirement accounts, many of the survey participants have implemented the changes to both retirement and non-retirement accounts.<sup>456</sup>

To date, the survey participants have incurred compliance costs of \$600 million, although the costs vary by the size of the respondent. For instance, large firms with net capital in excess of \$1 billion are expected to have start-up and ongoing compliance costs of \$55 million and \$6 million, respectively, while firms between \$50 million and \$1 billion in net capital are expected to have start-up and ongoing compliance costs of \$16 million and \$3 million, respectively. The SIFMA Study estimates that total start-up compliance costs for large and medium-size firms combined will be approximately \$4.7 billion, compared to the DOL’s estimate of between \$2 billion and \$3 billion, while ongoing costs will be approximately \$700 million per year (DOL’s estimates between \$463 million and \$679 million annually).

#### *C. Benefits, Costs, and Effects on Efficiency, Competition, and Capital Formation*

In formulating Regulation Best Interest, the Commission has considered the potential benefits of establishing a best interest standard of conduct for broker-dealers and the potential costs to the firms and retail customers of complying with the best interest obligation.

The best interest standard of conduct for broker-dealers would enhance the

quality of investment advice that broker-dealers provide to retail customers, help retail customers evaluate the advice received, and improve retail customer protection when soliciting advice from broker-dealers. By imposing a best interest obligation on broker-dealers, Regulation Best Interest would achieve these benefits by ameliorating the agency conflict between broker-dealers and retail customers. The three components of the best interest obligation, namely the Disclosure Obligation, the Care Obligation, and the Conflict of Interest Obligations work together towards ameliorating this agency conflict by addressing specific aspects of the conflict. In particular, these obligations, taken together, are meant to provide assurances to the retail customer that a broker-dealer provides a certain quality of recommendation that is consistent with the customer’s best interest.

The Disclosure Obligation, as discussed above, would reduce the informational gap with respect to certain elements of the relationship that are not currently fully disclosed. In particular, this obligation would foster retail customer awareness and understanding of key broker-dealer practices as well as material conflicts of interest associated with broker-dealer recommendations that would ultimately improve a retail customer’s assessment of the recommendations received.

The Care Obligation, as discussed above, is designed to result in the broker-dealer providing advice at a level of quality that better matches the expectations of retail customers, and, as a result, should enhance the quality of recommendations received.<sup>457</sup>

Proposed Regulation Best Interest would impose two concurrent Conflict of Interest requirements, as described above. These Conflict of Interest Obligations would enable broker-dealers to meet the Disclosure Obligation with regard to material conflicts of interest which would enhance customer understanding of broker-dealer conflicts associated with a recommendation and the extent to which those conflicts may influence a recommendation. This enhanced understanding of broker-dealer conflicts would aid retail customers in assessing, and deciding whether to act on, broker-dealer recommendations. Taken together, the Disclosure Obligation, the Care Obligation and the Conflict of Interest Obligations are designed to reduce the effects of conflicted broker-dealer advice and thereby improve retail customer protection.

above. In addition to broker-dealers, the DOL RIA estimates that other providers of ERISA or IRA accounts include: Approximately 10,600 federally registered investment advisers and 17,000 state-registered investment advisers (NASAA 2012/2013 Report), of which approximately 17,000 of federal and state investment advisers that are not dual registered, approximately 6,000 ERISA plan sponsors (2013 Form 5500 Schedule C), and approximately 400 life insurance companies (2014 SNL Financial Data). See The Department of Labor, Regulating Advice Markets: Regulatory Impact Analysis for Final Rule and Exemptions (Apr. 2016), available at <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2/conflict-of-interest-ria.pdf>.

<sup>454</sup> See The DOL Fiduciary Rule: A study on how financial institutions have responded and the resulting impacts on retirement investors, SIFMA and Deloitte (Aug. 9, 2017), available at <https://www.sifma.org/wp-content/uploads/2017/08/Deloitte-White-Paper-on-the-DOL-Fiduciary-Rule-August-2017.pdf> (“SIFMA Study”).

<sup>455</sup> The types of retirement accounts serviced by the participants in the SIFMA Study were not defined.

<sup>456</sup> In July 2017, the American Bankers Association (“ABA”) conducted a survey of 57 banks about their understanding of the Fiduciary Rule on products and the impact of the rule on products and services available to retirement investors. None of the survey respondents added to the retirement products or services available, while 30% eliminated or reduced products or services available to retirement investors in response to the Fiduciary Rule. Nearly 40% of banks further believed that the relationship with their customers has been altered as a result of the Fiduciary Rule applying only to retirement assets “since the bank is unable to provide holistic financial advice to its customers.” available at <https://www.aba.com/Advocacy/Issues/Documents/dol-fiduciary-rule-survey-summary-report.pdf>. See “Department of Labor Fiduciary Rule: National Survey of Financial Professionals” Financial Services Roundtable/ Harper Polling (July 2017), available at <http://www.fsroundtable.org/wp-content/uploads/2017/08/17.07-FSR-Presentation-1.pdf>. We note that the developments of business models and practices discussed herein reflect changes made voluntarily by firms in response to the DOL Fiduciary Rule, but were not necessarily required by the DOL Fiduciary Rule.

<sup>457</sup> See *supra* Section IV.D.2.

The Commission acknowledges, however, that Regulation Best Interest, through its component obligations, would potentially give rise to direct costs to broker-dealers and indirect costs to retail customers. For example, the requirement to act in the retail customer's best interest of the Care Obligation may lead some broker-dealers to determine that they no longer wish to make certain recommendations, and, as a result, may forgo some of the revenue stream associated with such recommendations. The disclosure requirements of the Disclosure Obligation and the Conflict of Interest Obligations would go beyond existing disclosure obligations, and, as a result, may impose direct costs on broker-dealers. Certain aspects of the Conflict of Interest Obligations may decrease the incentives of registered representatives to expend effort in providing quality advice, and, therefore, may impose a cost on retail customers if there is a decline in the quality of recommendations. Finally, other aspects of the Conflict of Interest Obligations may limit retail customer choice and, therefore, impose costs on retail customers, because broker-dealers, for compliance or business reasons, may determine to avoid certain products, despite the fact that those products may be beneficial to certain retail customers in certain circumstances.

Although, in establishing a best interest obligation for broker-dealers, the Commission considers these and other potential benefits and costs, the Commission notes that generally it is difficult to quantify such benefits and costs. Several factors make the quantification of the effects of the best interest obligation difficult. There is a lack of data on the extent to which broker-dealers with different business practices engage in disclosure and conflict mitigation activities to comply with existing requirements, and therefore how costly it would be to comply with the proposed requirements. The proposed rule would also give broker-dealers flexibility in complying with the best interest obligation, and, as a result, there could be multiple ways in which broker-dealers could satisfy this obligation, so long as it complies with its baseline obligations. Finally, any estimate of the magnitude of such benefits and costs would depend on assumptions about the extent to which broker-dealers are currently engaging in disclosure and conflict mitigation activities, how broker-dealers would choose to satisfy the best interest obligation, and, potentially, how retail customers

perceive the risk and return of their portfolio, the likelihood of acting on a recommendation that complies with the best interest obligation, and how the risk and return of their portfolio change as a result of how they act on the recommendation. Since the Commission lacks the data that would help narrow the scope of these assumptions, the resulting range of potential quantitative estimates would be wide and, therefore, not informative about the magnitude of the benefits or costs associated with the best interest obligation.

#### 1. Benefits

In this section, we discuss the benefits of a best interest standard of conduct, generally, and the benefits associated with the components of Regulation Best Interest, specifically.

Proposed Regulation Best Interest would create an express best interest obligation under the Exchange Act that consists of three components: The Disclosure Obligation, the Care Obligation, and the Conflict of Interest Obligations. These obligations, taken together, are meant to provide assurances to retail customers that broker-dealers provide a certain quality of recommendations that are consistent with the customers' best interest and to enhance retail customer protection. The best interest obligation, including the specific component obligations, may not be reduced or narrowed through contract with a retail customer.

As discussed in Section IV.2, explicit contracts may, in some cases, be inefficient means of ameliorating agency costs. In such cases, legal and regulatory obligations can provide alternative and more efficient tools to ameliorate these costs. For example, FINRA rules require broker-dealers making recommendations to: (i) Have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors, and (ii) based on a particular customer's investment profile, have a reasonable basis to believe that the recommendation is suitable for that customer. Moreover, under FINRA rules, a broker-dealer or associated person who has actual or *de facto* control over a customer's account must have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, is not excessive and unsuitable for the customer when taken together in light of the customer's investment profile.

In the absence of these rules, these requirements are all provisions that could, at least theoretically, be included in broker-dealer account agreements

with retail customers. Including these provisions would be meant to provide assurance to the retail customer that a broker-dealer provides a certain quality of recommendations. But inclusion of such provisions would likely have limited effectiveness because the retail customer would have little, if any, ability to confirm the broker-dealer's compliance with the provisions. If these provisions regarding the quality of advice were left open to contract, it is equally likely that the broker-dealer (as the more informed party) would be able to offer less optimal terms regarding the quality of advice to be provided to the retail customer.

Proposed Regulation Best Interest, through the Disclosure, the Care, and the Conflict of Interest Obligations, would incorporate and go beyond current broker-dealer obligations under federal securities laws and SRO rules in ways that would ameliorate the agency conflict between broker-dealers and retail customers and would create a number of potentially significant benefits for retail customers.

As discussed in more detail below, the Disclosure Obligation would foster retail customer awareness and understanding of certain specified information regarding the retail customer's relationship with the broker-dealer as well as material conflicts of interest associated with broker-dealer recommendations. As a result, this obligation would reduce the informational gap between a broker-dealer making a recommendation and a retail customer receiving that recommendation, which, in turn, may cause the retail customer to act differently with regard to the recommendation. For example, the retail customer may reject a broker-dealer recommendation that she would otherwise not reject absent the new information made available by the Disclosure Obligation. Anticipating a potential change in the behavior of the retail customer with respect to acting on recommendations as a result of the Disclosure Obligation, a broker-dealer may adjust its own behavior by providing recommendations that are less likely to be rejected by the retail customer. By virtue of being tailored to the retail customer's anticipated behavior, these recommendations are more likely to be in the retail customer's best interest, and therefore of higher quality relative to the recommendations that the broker-dealer would supply absent this obligation. Thus, the Disclosure Obligation would enhance the quality of recommendations that broker-dealers provide to retail customers. Furthermore, to the extent

that uncertainty about a broker-dealer's conflicts of interest associated with a recommendation complicates a retail customer's evaluation of the recommendation, the Disclosure Obligation would reduce that uncertainty and, therefore, would help retail customers better evaluate broker-dealer recommendations.

Similarly, the Care Obligation would allow broker-dealers to provide recommendations at a level of quality that better matches the expectations of its retail customers, and, therefore, would enhance the quality of recommendations that broker-dealers provide to retail customers.

Finally, the Conflict of Interest Obligations would require broker-dealers to establish, maintain, and enforce policies and procedures that are reasonably designed to identify and disclose or eliminate material conflicts of interest and establish, maintain, and enforce policies and procedures that are reasonably designed to identify and eliminate, or disclose and mitigate, material conflicts of interest arising from financial incentives associated with their recommendations. Such policies and procedures would benefit retail customers because they would be designed to reduce conflicts of interest that may motivate the behavior of associated persons of broker-dealers and thereby enhance the quality of the recommendations that they provide to their retail customers. Furthermore, these obligations work in conjunction with the Disclosure Obligation by including requirements designed to reduce the uncertainty with respect to whether a broker-dealer recommendation is subject to conflicts of interest. In particular, the Conflict of Interest Obligations would benefit retail customers by helping them better evaluate the recommendations received from broker-dealers.

#### a. Disclosure Obligation

Proposed Regulation Best Interest would establish the Disclosure Obligation, which would foster a retail customer's awareness and understanding of specified information regarding the relationship with the broker-dealer as well as material conflicts of interest associated with broker-dealer recommendations. To meet the Disclosure Obligation, the Commission would consider the following to be examples of material facts relating to the scope and terms of the relationship with the retail customer that a broker-dealer would be required to disclose in writing: (1) That it is acting in a broker-dealer capacity with respect to the recommendation; (2) fees

and charges that apply to the retail customer's transactions, holdings, and accounts; and (3) type and scope of services provided by the broker-dealer. Additionally, a broker-dealer would be required to disclose in writing all material conflicts of interest that are associated with the recommendation.

Currently, broker-dealers are not subject to an explicit and broad disclosure obligation under the Exchange Act. However, broker-dealers may provide information about their services and accounts, which may include disclosure about a broker-dealer's capacity, fees, and conflicts on their firm websites and in their account opening agreements. In addition, as noted above, broker-dealers are currently subject to specific disclosure obligations when making recommendations. Broker-dealers generally may be liable under federal securities laws' antifraud provisions if they do not give "honest and complete information" or disclose any material adverse facts or material conflict of interest, including economic self-interest. Many of these existing disclosure obligations depend on the facts and circumstances around recommendations, and different broker-dealers may comply with them differently. In addition, these disclosure obligations may not always produce information that is sufficiently relevant to a recommendation to assist a retail customer in meaningfully evaluating the recommendation. For instance, retail customers may not be aware of or understand the broker-dealer's conflicts of interest.<sup>458</sup>

The disclosure obligations for broker-dealers under Regulation Best Interest are more express and more comprehensive compared to existing disclosure requirements and liabilities. Namely, a broker-dealer that makes recommendations to a retail customer would be required to provide the retail customer with sufficiently specific facts about any material conflicts of interest such that the retail customer would be able to understand the conflict and make an informed decision about the broker-dealer recommendations. The Commission has provided preliminary guidance above on aspects of disclosure by a broker-dealer to a retail customer; this disclosure would help the retail customer understand specified information regarding the relationship with the broker-dealer, including the broker-dealer's material conflicts of interest.

In the case of retail customers who have both brokerage and advisory

accounts with the same financial professional, such as dual-registrants, it may not always be clear whether the financial professional is acting in a capacity of broker-dealer or investment adviser when providing advice.<sup>459</sup> This information may be useful to the retail customer when evaluating the advice received. For instance, the cost to the retail customer of acting on such advice may depend on whether the advice is tied to the retail customer's brokerage or advisory account.

By articulating an explicit disclosure requirement under the Exchange Act as part of the best interest obligation, the Disclosure Obligation would facilitate improved disclosure practices among broker-dealers. In addition, the Disclosure Obligation would facilitate retail customer awareness and understanding of certain key facts concerning their relationship with a broker-dealer, as well as conflicts of interest, and would provide retail customers with sufficiently specific facts to help them evaluate a broker-dealer recommendation. As a result, the Disclosure Obligation ameliorates the agency conflict between retail customers and broker-dealers, and therefore provides a potentially important benefit to investors in the form of reduced agency conflict between retail customers and broker-dealers.

The magnitude of the benefit from the reduced agency conflict would depend on a number of determinants, such as how retail customers perceive the risk and return of their portfolio, how they would act on a recommendation given the new information made available by the Disclosure Obligation, and, finally, how the risk and return of their portfolio would change as a result of acting on a recommendation. Given the number and complexity of assumptions, the Commission lacks the data that would allow it to narrow the scope of the assumptions regarding these determinants and estimate the magnitude of the benefit.

#### b. Exercise Reasonable Diligence, Care, Skill, and Prudence

As noted above, the Care Obligation of the proposed rule would go beyond the existing broker-dealer obligations under FINRA's suitability rule by requiring that broker-dealers act in the best interest of their retail customers, without placing the financial or other interest of the broker-dealer or associated person making the recommendation ahead of the interest of the retail customer. Furthermore, the Care Obligation does not include an

<sup>458</sup> See *supra* discussion in Section I.L.4.

<sup>459</sup> See *supra* discussion in Section I.L.4.

element of control, unlike the quantitative suitability prong of FINRA's suitability rule.

The new requirements of the Care Obligation of proposed Regulation Best Interest may restrict broker-dealers from making certain recommendations. For instance, broker-dealers would not be able to make recommendations to retail customers that comply with FINRA's suitability rule if they do not also comply with all the requirements of the Care Obligation. While the impact of the Care Obligation restrictions on broker-dealer recommendations to retail customers would depend largely, as noted earlier, on the facts and circumstances related to each recommendation and the investment profile of the retail customer receiving that recommendation, the fact that the Care Obligation incorporates and goes beyond existing broker-dealer suitability obligations may yield certain benefits for retail customers. For instance, to the extent that currently broker-dealers comply at all times with FINRA's suitability requirements but do not always account for the retail customer's best interest, as proposed here, when choosing between securities with similar payoffs but different cost structures, the Care Obligation would encourage broker-dealers to recommend a security that would be more appropriately suited to achieve the retail customer's objectives. Thus, by promoting recommendations that are better aligned with the objectives of the retail customer, the Care Obligation of proposed Regulation Best Interest would provide an important benefit to retail customers, ameliorating the agency conflict between broker-dealers and retail customers and, in turn, improving the quality of recommendations that broker-dealers provide to retail customers.

The Commission is unable to quantify the magnitude of these benefits to retail customers for a number of reasons. First, broker-dealer recommendations would depend largely on the facts and circumstances related to each recommendation and the investment profile of the retail customer receiving that recommendation. Second, broker-dealers currently do not have an explicit obligation to act in their customers' best interest when making recommendations. Finally, the magnitude of these benefits to retail customers would depend on how retail customers generally perceive the risk and return of their portfolio, the likelihood of acting on a recommendation that complies with the best interest obligation, and, ultimately, how the risk and return of their

portfolio change as a result of how they act on the recommendation. Any estimate of the magnitude of such benefits would depend on assumptions about the facts and circumstances surrounding a recommendation, the investment profile of the retail customer, how retail customers perceive the risk and return of their portfolio, the determinants of the likelihood of acting on a recommendation that complies with the best interest obligation, and, finally, how the risk and return of their portfolio change as a result of how they act on the recommendation. Because the Commission lacks the data that would help narrow the scope of these assumptions, the resulting range of potential estimates would be wide, and, therefore, would not be informative about the magnitude of these benefits to retail customers.

Another way in which the proposed rules would incorporate and go beyond existing standards is by requiring a broker-dealer to have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best 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, regardless of whether the broker-dealer has actual or *de facto* control over a retail customer account. This represents a heightened standard relative to obligations under federal securities laws and under FINRA's concept of quantitative suitability in two ways. First, this proposed requirement applies a best interest standard to a series of recommendations, rather than requiring broker-dealers to merely have a reasonable basis for believing that a series of recommendations are not excessive or unsuitable. Second, by removing the control element, the proposed requirement would expand the scope of retail customers that could benefit from existing suitability requirements to those retail customers who, while retaining control over their own accounts, nevertheless accept a series of broker-dealer recommendations.

The Commission is unable to quantify the magnitude of the benefits that retail customers could receive as a result of the new obligations for broker-dealers that provide a series of recommendations to retail customers for largely the same reasons that make the quantification of the other Care Obligation benefits, as discussed above, difficult.<sup>460</sup>

<sup>460</sup> The DOL RIA estimates that due to one source of adviser conflicts, namely that conflict related to

c. Obligation To Establish, Maintain, and Enforce Written Policies and Procedures Reasonably Designed To Identify and at a Minimum Disclose, or Eliminate, All Material Conflicts of Interest Associated With a Recommendation

Regulation Best Interest would include two requirements relating to the treatment of conflicts. The first requirement under the Conflict of Interest Obligations would require a broker-dealer<sup>461</sup> to establish, maintain, and enforce written policies and procedures reasonably designed to identify and at a minimum disclose, or

underperformance associated with front-end load mutual funds, retirement investors will underperform no-load mutual funds by approximately 0.50% to 1.00%, on average, which translates to aggregate losses of between \$95 billion to \$189 billion over 10 years. See The Department of Labor, *Regulating Advice Markets: Regulatory Impact Analysis for Final Rule and Exemptions* (Apr. 2016), available at <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2/conflict-of-interest-ria.pdf>. The Department of Labor further estimates that its Fiduciary Rule and the BIC Exemption will reduce those losses attributed to underperformance of front-end load mutual funds by \$33 billion to \$36 billion over 10 years. *But see* Letter from Craig Lewis (Aug. 31, 2017) (offering a critique of the DOL RIA). Generally, although the DOL RIA provides potential estimates of investor harm and gains to investors as a result of that agency's rule, the Commission has not incorporated those estimates into its own economic analysis because of the differences in scope of the intended effects of Regulation Best Interest. Moreover, because of the range of investor risk profiles and the diversity of products offered by broker-dealers outside of the retirement account context, the Commission is unable to apply the DOL's analytical framework—which focuses primarily on the differences between load and no-load mutual funds as well as analyses that compare broker-dealer advised investments to unadvised direct investments—to its own analysis. With respect to the analysis of costs and benefits associated with proposed Regulation Best Interest, the relevant metric is the differences between broker-dealer advised accounts subject to the current legal framework and broker-dealer advised accounts subject to the proposed rule overlaid on the existing legal framework. See also Council of Economic Advisers, *The Effects of Conflicted Investment Advice on Retirement Savings*, 2015, available at [https://obamawhitehouse.archives.gov/sites/default/files/docs/cea\\_coi\\_report\\_final.pdf](https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf), (using the same approach as the DOL RIA, estimates annual losses to retirement investors from conflicted advice at \$17 billion per year). See also Economic Policy Letter, *supra* note 27. The Consumer Federation of America estimated annual losses from conflicted investment advice between \$20 billion and \$40 billion per year, while PIABA estimated annual losses at approximately \$21 billion per year. See CFA 2017 Letter; PIABA Letter.

<sup>461</sup> The proposed Conflict of Interest Obligations apply solely to the broker or dealer entity, and not to the natural persons who are associated persons of a broker or dealer. For purposes of discussing the Conflict of Interest Obligations, the term "broker-dealer" refers only to the broker-dealer entity, and not to such individuals. However, the policies and procedures a broker-dealer establishes, maintains, and enforces, pursuant to the proposed Conflict of Interest Obligation, would apply to a broker-dealer's registered representative's conflicts of interest.



eliminate, all material conflicts of interest that are associated with a recommendation. Conflicts of interest may arise for a number of reasons. For example, a broker-dealer may be in a position to recommend: Proprietary products, products of affiliates, or a limited range of products; one share class versus another share class of a mutual fund; securities underwritten by the firm or a broker-dealer affiliate; the roll over or transfer of assets from one type of account to another (such as recommendations to rollover or transfer assets in an ERISA account to an IRA, when the recommendation involves a securities transaction); and allocation of investment opportunities among retail customers. This Conflict of Interest Obligation may benefit retail customers to the extent that a broker-dealer establishes, maintains and enforces policies and procedures to disclose, or eliminate, a material conflict of interest that may have a negative impact on its recommendations to retail customers.

As noted in our earlier discussion of the Disclosure Obligation, a broker-dealer that determines to address a conflict of interest identified through policies and procedures by disclosing it should provide the retail customer, in writing, with sufficiently specific facts so that the customer is able to understand the material conflicts of interest and is able to make an informed decision about the broker-dealer recommendations.

The benefits to retail customers of this disclosed information have been discussed earlier under the Disclosure Obligation. These benefits are difficult to quantify for the same reasons that the benefits of the overall Disclosure Obligation in Section IV.D.1.a. are difficult to quantify.

As noted earlier, as an alternative to addressing a conflict of interest identified through policies and procedures by disclosing it, a broker-dealer may choose, instead, to satisfy this Conflict of Interest Obligation by eliminating it altogether. If a broker-dealer addresses the material conflict of interest by eliminating it, a retail customer benefits from receiving a recommendation that is free of that particular conflict of interest.

Generally, we preliminarily believe that having express Conflict of Interest Obligations would result in broker-dealers establishing policies and procedures focusing specifically on identifying and evaluating conflicts and determining whether each of the identified conflicts is material and should be disclosed or eliminated. We also preliminarily believe that broker-dealers may be more inclined to

evaluate and address material conflicts of interest and eliminate more egregious conflicts of interest to the extent that disclosure of the conflict would result in reputation risk. Further, having a clearly defined obligation that would require, among other things, that a broker-dealer establish written policies and procedures reasonably designed to identify and disclose, or eliminate, all material conflicts of interest associated with a recommendation may result in increased retail customer confidence in the recommendation received. Finally, the Conflict of Interest Obligation may improve retail customer welfare, to the extent that the obligation permits retail customers to understand better which recommendations, within a broader set of suitable recommendations, are or are not conflicted and the extent and nature of any such conflicts, while maintaining retail customer access to a broad variety of recommendations.

**d. Obligation To Establish, Maintain, and Enforce Written Policies and Procedures Reasonably Designed To Identify and Disclose and Mitigate, or Eliminate, Material Conflicts of Interest Arising From Financial Incentives Associated With a Recommendation**

The Conflict of Interest Obligations of proposed Regulation Best Interest include the additional requirement that a broker or dealer, establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with a recommendation.

This Conflict of Interest Obligation would apply to material conflicts of interest that arise from financial incentives. As discussed in more detail above, we interpret a material conflict of interest as a conflict of interest that a reasonable person would expect might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested. Material conflicts of interest that arise from financial incentives include, but are not limited to, conflicts arising from compensation practices such as how a broker-dealer compensates its employees, and how a broker-dealer is compensated by third-parties for whom it may act as a distributor or service provider.

As noted in our earlier discussion of the Disclosure Obligation, a broker-dealer that determines to address a conflict of interest arising from financial incentives identified through policies and procedures by disclosing and mitigating it should provide the retail customer, in writing, with sufficiently

specific facts so that the retail customer is able to understand the material conflicts of interest and is able to make an informed decision about the broker-dealer's recommendations. The benefits to retail customers of this disclosed information have been discussed earlier under the Disclosure Obligation.

As noted earlier, as an alternative to addressing conflicts of interest through disclosure and mitigation of a material conflict of interest arising from financial incentives, a broker-dealer may choose, instead, to satisfy this Conflict of Interest Obligation by eliminating the conflict altogether. If a broker-dealer establishes policies and procedures to address a conflict of interest through eliminating a material conflict of interest arising from financial incentives associated with a recommendation, a retail customer benefits from receiving a recommendation that is free of that particular conflict of interest. In other words, if a retail customer receives a broker-dealer recommendation and written disclosure about certain material conflicts of interest arising from financial incentives associated with the recommendation, the retail customer can expect that the conflicts of interest arising from financial incentives and that are omitted from such disclosure are either not material or eliminated. This may benefit retail customers to the extent that the absence of certain conflicts of interest arising from financial incentives associated with a recommendation may increase retail customers' trust in the advice they obtain and in financial markets.<sup>462</sup> Moreover, in those circumstances where a broker-dealer chooses to address a conflict of interest through elimination because disclosure and mitigation of those conflicts of interest may be too challenging, the broker-dealer would simplify the evaluation of the recommendation by the retail customer.

However, unlike other material conflicts of interest, under proposed Regulation Best Interest, developing policies and procedures to address material conflicts of interest arising from financial incentives through disclosure alone would not be sufficient. The requirement to establish, maintain, and enforce policies and procedures to mitigate conflicts of interest related to financial incentives is a significant expansion of current broker-dealer requirements to address conflicts. As discussed in Section II.D.3.b., the Commission has provided preliminary guidance on reasonably designed policies and procedures for identifying and disclosing and

<sup>462</sup> See *supra* Section IV.B.1.

mitigating, or eliminating, material conflicts of interest arising from financial incentives that allow broker-dealers the flexibility to comply with the Conflict of Interest Obligations based on each firm's circumstances. This approach allows broker-dealers the flexibility to establish policies and procedures reasonably designed to identify and disclose and mitigate, potential conflicts of interest arising from financial incentives and to develop supervisory systems that would help them maintain and enforce their policies and procedures in a manner that reflects their business practices and that focuses on areas of their business practices where heightened concern may be warranted.

The Commission is unable to quantify the size of these benefits for several reasons. First, Regulation Best Interest would provide broker-dealers flexibility in choosing whether to address a conflict of interest arising from financial incentives through disclosure and mitigation, or elimination and flexibility in choosing among methods of mitigation. Second, the size of these benefits would depend on how retail customers generally perceive the risk and return of their portfolio, the likelihood of acting on a recommendation that complies with the best interest obligation, and, ultimately, how the risk and return of their portfolio change as a result of how they act on the recommendations. Any estimate of the size of such benefits would depend on assumptions about how broker-dealers choose to comply with this requirement of the Conflict of Interest Obligations, how retail customers perceive the risk and return of their portfolio, the determinants of the likelihood of acting on a recommendation that complies with the best interest obligation, and, finally, how the risk and return of their portfolio change as a result of how they act on the recommendation. Since the Commission lacks the data that would help narrow the scope of these assumptions, the resulting range of potential estimates would be wide, and, therefore, not informative about the magnitude of these benefits.

## 2. Costs

In this section, we discuss the costs of a best interest standard of conduct, generally, and the costs associated with the components of Regulation Best Interest, specifically.

As discussed in more detail below, proposed Regulation Best Interest would entail direct costs for broker-dealers and indirect costs for retail customers and other parties with a stake in the market

for investment advice (*e.g.*, product sponsors). The magnitude of the costs will depend on several factors: (1) How broker-dealers would choose to comply with the best interest obligation, (2) whether broker-dealers would pass on some of the costs of complying with the best interest obligation to the retail customers, and (3) the extent to which broker-dealers are currently acting in a retail customer's best interest when providing advice, and complying with the existing disclosure requirements and liabilities. Regulation Best Interest would impose a best interest obligation on broker-dealers that would incorporate and go beyond existing suitability obligations under the federal securities laws and SRO rules. The overall cost of proposed Regulation Best Interest would depend on the costs that each of its component obligations, namely the Disclosure, the Care, and the Conflict of Interest Obligations, would impose on broker-dealers, retail customers, and other parties such as product sponsors with a stake in the market for financial advice.

For instance, with respect to the Disclosure Obligation, the disclosure requirements would incorporate and go beyond existing disclosure obligations and liabilities, and, as a result, may impose direct costs on broker-dealers.

With respect to the Care Obligation, the requirement to have a reasonable basis to believe that a recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the risks and rewards associated with the recommendation may impose a cost on the broker-dealers that determine that they no longer wish to make certain recommendations to brokerage customers, and, as a result, forgo some of the revenue stream associated with such recommendations. Other requirements of this obligation may impose operational and legal costs on broker-dealers.

Finally, with respect to Conflict of Interest Obligations, the requirement to establish, maintain, and enforce written policies and procedures to eliminate material conflicts of interest as an alternative to disclosing such conflicts may impose potential costs on broker-dealers to the extent that they determine to satisfy this requirement by no longer offering certain recommendations or services, and, therefore, forgo some of the revenue stream associated with such recommendations or services. The requirement to establish, maintain, and enforce written policies and procedures to mitigate or eliminate certain material conflicts of interest arising from financial incentives may alter the

incentives of registered representatives to expend effort in providing quality advice, and, therefore, may impose a cost on retail customers due to the potential decline in the quality of recommendations. The same requirement may limit retail customer choice, and therefore impose costs on retail customers, because broker-dealers, for compliance or business reasons, may determine to avoid recommending certain products to retail brokerage customers, despite the fact that these products may be beneficial to certain retail customers in certain circumstances.

The Commission acknowledges that, taken together, the proposed rules may generate tension between broker-dealers' regulatory requirements and their incentives to provide high quality recommendations to retail customers, including by recommending costly or complex products. Retail customers may have diverse and complex investment needs and goals and may benefit from tailored trading strategies and financial products that may entail higher costs (*e.g.*, due to the effort that broker-dealers may have to expend to understand the product and which products would best fit the needs of their retail customers). While this proposal is designed to incorporate and go beyond the existing broker-dealer regulatory regime and ameliorate certain conflicts of interest between retail customers and financial firms, it is not intended to restrict broker-dealers from recommending higher cost products or services to retail customers when appropriate to meet a retail customer's needs or goals, so long as these recommendations meet proposed Regulation Best Interest.<sup>463</sup>

### a. Standard of Conduct Defined as Best Interest

As noted above, the proposed rule would establish a best interest standard of conduct for broker-dealers when making recommendations to retail customers. Below, we discuss the operational and programmatic costs anticipated as a result of the proposed rule.

#### (1) Operational Costs

Broker-dealers typically provide training to their employees with respect

<sup>463</sup> The DOL RIA estimates that the aggregate costs associated with the implementation and compliance with the DOL Fiduciary Rule and the BIC Exemption would be between \$10 billion and \$31.5 billion over 10 years, with an expected cost of \$16.1 billion. *But see* Letter from Craig Lewis (Aug. 31, 2017) (offering a critique of the DOL RIA). As noted above, because of the differences in the scope of Regulation Best Interest, the Commission is not incorporating these estimates into its own analysis.

to relevant legal and regulatory requirements.<sup>464</sup> Firms generally prefer face-to-face training where possible, but large firms tend to use computer-based training to reach their dispersed employees.<sup>465</sup> The proposed rule would create a best interest standard of conduct for broker-dealers. While incorporating the existing standards of conduct for broker-dealers established by the federal securities laws and SRO rules, this rule would enhance existing standards. Consequently, complying with the best interest standard may require additional training for broker-dealer employees. The cost of this training may depend on whether a broker-dealer and its associated persons are already behaving in a way that is consistent with the best interest standard, and whether broker-dealer employees are trained to behave in this manner. In particular, broker-dealers that currently are not behaving consistent with the best interest standard and that are not training their employees to behave in this manner may incur higher training costs. For example, firms already provide training with respect to FINRA suitability rules. As a result, we believe that the costs associated with providing training with respect to the Care Obligation of the proposed rule would be incremental for broker-dealers that are behaving consistent with the best interest standard, but potentially substantial for those broker-dealers that are not. Similarly, broker-dealers currently provide training on material conflicts of interest.<sup>466</sup> However, the Conflict of Interest Obligations of the proposed rule would be different from the existing requirements or liabilities to disclose, and as a result, we believe that the costs associated with providing training with respect to the Conflict of Interest Obligations of the proposed rule could be potentially significant.

In addition to the potential costs described above, certain factors might mitigate the potential costs of proposed Regulation Best Interest. As discussed earlier in Section IV.C, in addition to obligations imposed by the existing standard of conduct, broker-dealers that are servicing retirement accounts would also be subject to obligations imposed by the DOL Fiduciary Rule and the BIC Exemption.<sup>467</sup> Regulation Best Interest would apply consistent regulation to

recommendations involving retail customers' retirement and non-retirement accounts. To the extent that there might be a discrepancy between broker-dealer obligations that apply to retirement accounts and those that apply to non-retirement accounts, the proposed rule, through its consistent approach to regulating recommendations involving retail customers' retirement and non-retirement accounts, may reduce any costs associated with such discrepancy. Similarly, to the extent that broker-dealers that do not necessarily service retirement accounts might be subject to and comply with similar overlapping regulations that impose costs on broker-dealers (*e.g.*, state laws that impose fiduciary obligations),<sup>468</sup> proposed Regulation Best Interest may reduce any such costs.

While all broker-dealers would have to comply with Regulation Best Interest, broker-dealers that service retirement accounts would also have to comply with the DOL Fiduciary Rule and the BIC Exemption. Since the best interest obligation of the proposed rule does not incorporate all the requirements that the DOL Fiduciary Rule and the BIC Exemption, broker-dealers that service retirement accounts may incur additional costs as a result of overlapping but not identical regulations. For example, broker-dealers that implement the BIC Exemption would be subject to the disclosure regime imposed by the proposed rule, as well as the disclosure requirements mandated by the BIC Exemption.<sup>469</sup> Similarly, broker-dealers that are not necessarily servicing retirement accounts but could be subject to overlapping but not identical regulation may incur additional costs of complying with such regulation. However, since Regulation Best Interest would not change how broker-dealers would comply with the DOL Fiduciary Rule and the BIC Exemption or other current overlapping regulations, broker-dealers may incur the costs of complying with such regulations even absent an explicit best interest obligation.

## (2) Programmatic Costs

The proposed rule may impose programmatic costs on broker-dealers by limiting their ability to make certain recommendations or deterring them from making certain recommendations. To the extent that broker-dealers are currently able to generate revenues from

securities recommendations that are consistent with FINRA's suitability rule but not consistent with this proposed best interest obligation, those revenues would be eliminated under the proposed rule. Specifically, if a broker-dealer determines to no longer recommend a product because that product is inferior to another product with similar payoffs but lower cost, the revenue loss would consist of the difference between the cost of the former product and the cost of the latter product. While the FINRA suitability standard does not explicitly prohibit a broker-dealer from putting its interest ahead of the customer's, FINRA interpretations suggest that a broker-dealer may not put its interest ahead of the customer's.<sup>470</sup> The Commission is unable to quantify the magnitude of this potential revenue loss because of the difficulty in identifying systematically recommendations that are consistent with FINRA's suitability rule but not with the proposed rule. The reason why such identification is difficult is because a broker-dealer recommendation depends largely, as noted earlier, on the facts and circumstances related to that recommendation and the investment profile of the retail customer receiving that recommendation. Any estimate of the magnitude of the potential revenue loss would depend on assumptions about a recommendation's potential facts and circumstances and the investment profile of the retail customer receiving the recommendation. Since the Commission lacks the data that would help narrow the scope of these assumptions, the resulting range of potential estimates would be wide, and, therefore, not informative about the magnitude of the potential revenue loss.

Broker-dealers may also face increased costs due to enhanced legal exposure as a result of a potential increase in retail customer arbitrations.<sup>471</sup> Such costs may also be incurred to the extent broker-dealers believe that such an increase may occur and therefore choose to expend

<sup>470</sup> See Rule 2111, FAQ—Q7.1, available at <http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq>.

<sup>471</sup> Moreover, we note that the proposed rule creates an enhanced standard of conduct for broker-dealers under the Exchange Act. One key difference and enhancement resulting from the obligations imposed by Regulation Best Interest as compared to a broker-dealer's existing obligations under the antifraud provisions of the federal securities laws, is that the antifraud provisions require an element of fraud or deceit, which would not be required under Regulation Best Interest. More specifically, the Care Obligation could not be satisfied by disclosure. To the extent that broker-dealers believe that they may face enhanced legal exposure, they may choose to incur costs in anticipation of any enforcement action.

<sup>464</sup> See FINRA, "Report on Conflicts of Interest," Oct. 2013.

<sup>465</sup> *Id.* at 15.

<sup>466</sup> *Id.* at 15.

<sup>467</sup> As discussed above, the DOL Fiduciary Rule was vacated by the United States Court of Appeals for the Fifth Circuit on March 15, 2018. See *supra* note 51.

<sup>468</sup> See *supra* note 442.

<sup>469</sup> The disclosure requirements for the BIC Exemption are discussed in the baseline. See Section IV.C.2, and *supra* note 52.

resources to prepare for additional arbitration claims. Most, if not all, brokerage agreements contain clauses that require retail customers to arbitrate disputes with a broker-dealer through FINRA's Office of Dispute Resolution.<sup>472</sup> In the event that a brokerage agreement contains no such arbitration clause, Rule 12201 of FINRA's Code of Arbitration Procedure for Customer Disputes (the "FINRA Code") allows a customer to compel a broker-dealer or person associated with a broker-dealer to arbitrate a dispute.<sup>473</sup> The FINRA Code does not require a customer to allege a cause of action when pursuing arbitration against a broker-dealer; rather, a customer need only specify "relevant facts and remedies requested."<sup>474</sup> Nevertheless, it is unclear whether or to what extent the adoption of Regulation Best Interest would affect the number of retail customer arbitrations, since many retail customer arbitrations are already predicated on facts alleging that a broker-dealer breached a fiduciary duty or breached its suitability obligations.<sup>475</sup>

#### b. Disclosure Obligation

Proposed Regulation Best Interest would impose a number of obligations on broker-dealers, including the Disclosure Obligation.

As noted earlier, the Disclosure Obligation would incorporate and go beyond the existing disclosure obligations and liabilities by establishing an explicit disclosure requirement for broker-dealers under the Exchange Act, by facilitating a more uniform level of disclosure of the material scope and terms of the relationship between broker-dealer and retail customer as well as broker-dealer material conflicts of interest across broker-dealers and by providing retail

customers with sufficiently specific facts concerning their relationship with broker-dealers.

As discussed earlier, certain requirements of the Disclosure Obligation could be satisfied in part by complying with the requirements of the concurrent proposed Relationship Summary and Regulatory Status Disclosure. For instance, with respect to the requirement to disclose a broker-dealer's capacity, a standalone broker-dealer would be able to satisfy fully the requirement by delivering the Relationship Summary to the retail customer and by maintaining a reasonable basis to believe that a retail customer had been delivered the Relationship Summary prior to or at the time when a recommendation was made, and by complying with the Regulatory Status Disclosure. In contrast, a dual-registrant would only be able to satisfy partially the requirement to disclose a broker-dealer's capacity by complying with the Relationship Summary rule and the Regulatory Status Disclosure. Given that a dual-registrant may act in broker-dealer capacity or investment adviser capacity when providing advice to a retail customer, a dual-registrant would have to comply with the Disclosure Obligation expressly.<sup>476</sup> Thus, while standalone broker-dealers that comply with the Relationship Summary rule would not incur additional costs to comply with this requirement of the Disclosure Obligation, dual-registrants would. However, dual-registrants would be given flexibility with respect to the form, timing, or method of satisfying this requirement of the Disclosure Obligation when they make recommendations in the capacity of broker-dealer.

With respect to the requirement to disclose a broker-dealer's fees, the Disclosure Obligation may enhance the informativeness of the broker-dealer disclosure to retail customers over the existing disclosure practices. Currently, disclosure practices with respect to a broker-dealer's fees may not be sufficiently informative to remove a retail customer's uncertainty about the fees that it would have to pay by acting on a broker-dealer recommendation.<sup>477</sup> The proposed Relationship Summary rule would require broker-dealers to disclose general information about the types of fees that retail customers would be expected to pay when receiving

services from broker-dealers, but not quantitative fee information. However, in addition to the Relationship Summary, the Disclosure Obligation would foster more detailed fee disclosure, and would require broker-dealers to provide, at the minimum, additional detail about the fees described in the Relationship Summary, such as fee amounts, percentages and ranges. Thus, even for those broker-dealers that comply with the Relationship Summary, the Disclosure Obligation with respect to disclosure of a broker-dealer's fees would impose additional costs on broker-dealers. However, broker-dealers would have flexibility as to the form and timing of how to satisfy this requirement of the Disclosure Obligation.

Finally, broker-dealers would be able to satisfy the requirement to disclose all material conflicts of interest by complying with the requirements of the Conflict of Interest Obligations. Thus, for broker-dealers that comply with the Conflict of Interest Obligations, the Disclosure Obligation with respect to disclosure of material conflicts of interest would impose no additional costs on broker-dealers. The Conflict of Interest Obligations would impose costs on broker-dealers, and those costs are discussed in more detail below.

As noted above, proposed Regulation Best Interest would give broker-dealers flexibility with respect to the form, timing, or method of complying with the disclosure requirements. While this flexibility would help broker-dealers tailor their form, timing, or method of complying with the disclosure requirements to their business practices, it may also impose a cost on broker-dealers because, in the absence of a mandated form, timing, or method of disclosure, broker-dealers would have to expend resources to develop standardized methods of disclosure that could be easily understood by their retail customers.

Finally, as discussed above, the requirement to create certain written records of information collected from and provided to a retail customer of the Disclosure Obligation may impose additional costs on broker-dealers. This new record-making requirement would amend Exchange Act Rule 17a-3 by adding new paragraph (a)(25) that would require that a broker-dealer create a record of all information collected from and provided to the retail customer pursuant to Regulation Best Interest. In addition, the Commission is proposing to amend Exchange Act Rule 17a-4(e)(5) to require broker-dealers to retain the records required pursuant to Rule 17a-3(a)(25) for at least six years.

<sup>472</sup> See SEC Investor Bulletin: Broker-Dealer/Customer Arbitration (Dec. 20, 2016), available at [https://www.sec.gov/oia/investor-alerts-bulletins/ib\\_arbitration.html](https://www.sec.gov/oia/investor-alerts-bulletins/ib_arbitration.html) ("[A]ccount opening agreements will almost always contain a provision binding the parties to arbitration in the event of a dispute . . . [FINRA] handles almost all securities industry arbitrations and mediations.").

<sup>473</sup> See FINRA Rule 12200 ("Parties must arbitrate a dispute under the Code if: Arbitration under the Code is either: (1) Required by a written agreement; or (2) Requested by the customer. . . ."). See also SEC Investor Bulletin: Broker-Dealer/Customer Arbitration (Dec. 20, 2016), available at [https://www.sec.gov/oia/investor-alerts-bulletins/ib\\_arbitration.html](https://www.sec.gov/oia/investor-alerts-bulletins/ib_arbitration.html).

<sup>474</sup> See FINRA Rule 12302.

<sup>475</sup> See FINRA Dispute Resolution Statistics, Top 15 Controversy Types in Customer Arbitrations, available at <https://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics#top15controversycustomers> (of cases served from January through October 2017, 1,529 cases alleged a breach of fiduciary duty; during that same period, 1,279 cases alleged a breach of suitability obligations).

<sup>476</sup> Financial professionals who are dually-registered, but who are affiliated with different standalone broker-dealers and investment advisers would have the same obligation.

<sup>477</sup> See, e.g., *supra* note 192.

The Commission is unable to fully quantify the costs of the Disclosure Obligation due to a number of factors. First, the Commission lacks data on the extent to which current disclosure practices are different from the disclosure requirements of the Disclosure Obligation. Second, given that the proposed rule would give broker-dealers flexibility in complying with the requirements of the Disclosure Obligation, there could be multiple ways in which broker-dealers may satisfy these requirements. Finally, the portion of compliance costs that broker-dealers may pass on to retail customers may depend on the costs that a retail customer would incur to switch from one broker-dealer to another or from a broker-dealer to an investment adviser.

While a range of estimates for the costs of the Disclosure Obligation may be difficult to obtain due to the potentially wide range of assumptions about these factors, preliminary estimates for the portion of these costs borne by broker-dealers may be obtained under specific assumptions. As discussed further in Section V.D, the Commission preliminarily believes that the preparation and delivery of standardized language, fee schedules, and standardized conflict disclosures that broker-dealers are expected to provide to retail customers to comply with the Disclosure Obligation would impose an initial aggregate burden of 5,808,703 hours and an additional initial aggregate cost of \$40.79 million as well as an ongoing aggregate burden of 1,965,564 hours on broker-dealers.<sup>478</sup>

<sup>478</sup> The estimate of the initial aggregate burden is based on the following calculation: 3,600 hours + 8,020 hours + 41,100 hours + 1,904,000 hours + 4,010 hours + 20,550 hours + 1,904,000 hours + 4,010 hours + 15,413 hours + 1,904,000 hours = 5,808,703 hours. As discussed in more detail in Section V.D., 3,600, 8,020, and 41,100 hours are preliminary estimates of the initial aggregate burden for the preparation of disclosure of capacity, type and scope, for dual registrants, small and large broker-dealers, respectively. 1,904,000 hours is the preliminary estimate of the initial aggregate burden for the delivery of the disclosure of capacity, type and scope to retail customers. 4,010 and 20,550 hours are preliminary estimates of the initial aggregate burden for the preparation of disclosure of fees for small and large broker-dealers, respectively. 1,904,000 hours is the preliminary estimate of the initial aggregate burden for the delivery of the disclosure of fees to retail customers. 4,010 and 15,413 hours are preliminary estimates of the initial aggregate burden for the preparation of disclosure of material conflicts of interest for small and large broker-dealers, respectively. 1,904,000 hours is the preliminary estimate of the initial aggregate burden for the delivery of the disclosure of material conflicts of interest to retail customers. The estimate of the initial aggregate cost is based on the following calculation: \$1.70 million + \$3.79 million + \$14.55 million + \$1.89 million + \$9.70 million + \$1.89 million + \$7.27 million = \$40.79 million. As discussed in more detail in Section V.D., \$1.70 million, \$3.79 million, and \$14.55

Thus, the Disclosure Obligation of proposed Regulation Best Interest would impose an initial aggregate cost of at least \$1,391.07 million and an ongoing aggregate annual cost of at least \$460.81 million on broker-dealers.<sup>479</sup> In addition, the Commission believes that the record-making obligation of proposed Rule 17a-3(a)(25) and the recordkeeping obligation of the proposed amendment to Rule 17a-4(e)(5) associated with the Disclosure Obligation and the obligations of proposed Regulation Best Interest would impose an initial aggregate burden of 19,678,777 hours and an additional initial aggregate cost of \$378,544 as well as an ongoing aggregate annualized burden of 3,173,334 hours on broker-dealers.<sup>480</sup> Thus, the record-making

million are preliminary estimates of the initial aggregate cost for the preparation of disclosure of capacity, type and scope, for dual registrants, small and large broker-dealers, respectively. \$1.89 million and \$9.70 million are preliminary estimates of the initial aggregate cost for the preparation of disclosure of fees for small and large broker-dealers, respectively. \$1.89 million and \$7.27 million are preliminary estimates of the initial aggregate cost for the preparation of disclosure of material conflicts of interest for small and large broker-dealers, respectively. The estimate of the ongoing aggregate burden is based on the following calculation: 2,520 hours + 3,208 hours + 41,100 hours + 380,800 hours + 1,604 hours + 8,220 hours + 761,600 hours + 802 hours + 4,110 hours + 761,600 hours = 1,965,564 hours. As discussed in more detail in Section V.D., 2,520, 3,208, and 41,100 hours are preliminary estimates of the ongoing aggregate burden for the preparation of disclosure of capacity, type and scope, for dual registrants, small and large broker-dealers, respectively. 380,800 hours is the preliminary estimate of the ongoing aggregate burden for the delivery of the disclosure of capacity, type and scope to retail customers. 1,604 and 8,220 hours are preliminary estimates of the ongoing aggregate burden for the preparation of disclosure of fees for small and large broker-dealers, respectively. 761,600 hours is the preliminary estimate of the ongoing aggregate burden for the delivery of the disclosure of fees to retail customers. 802 and 4,110 hours are preliminary estimates of the ongoing aggregate burden for the preparation of disclosure of material conflicts of interest for small and large broker-dealers, respectively. 761,600 hours is the preliminary estimate of the ongoing aggregate burden for the delivery of the disclosure of material conflicts of interest to retail customers.

<sup>479</sup> These estimates are calculated as follows: (96,703 hours of in-house legal counsel) × (\$409.37/hour for in-house counsel) + (5,712,000 hours for delivery for each customer account) × (\$229.46/hour for registered representative) + (86,428 hours for outside legal counsel) × (\$472/hour for outside legal counsel) = \$1,391.07 million, and (35,555 hours of in-house legal counsel) × (\$409.37/hour for in-house counsel) + (1,904,000 hours for delivery for each customer account) × (\$229.46/hour for registered representative) + (26,009 hours for in-house compliance counsel) × (\$359.81/hour for outside legal counsel) = \$460.81 million. The hourly wages for in-house legal and compliance counsel and registered representatives are obtained from SIFMA. The hourly rates for outside legal counsel are discussed in Section V.D.

<sup>480</sup> These estimates are based on the Commission's preliminary estimates, discussed in Section V.D, with respect to the initial and ongoing

obligation of proposed Regulation Best Interest would impose an initial aggregate cost of at least \$4,516.56 million and an ongoing aggregate annual cost of at least \$1,141.81 million on broker-dealers.<sup>481</sup>

#### c. Obligation To Exercise Reasonable Diligence, Care, Skill, and Prudence in Making a Recommendation

The Care Obligation of the proposed rule, as described above, would incorporate and go beyond a broker-dealer's existing obligations in two ways. First, the proposed obligation would draw on broker-dealers' existing well-established obligations for "customer-specific suitability," but would go beyond those obligations by requiring that the broker-dealer have a reasonable basis to believe that the recommendation is in the best interest of the retail customer based on the retail customer's investment profile. Second, the proposed rule would require a broker-dealer to have a reasonable basis to believe that a series of transactions is not excessive and is in the retail customer's best interest, regardless of whether the broker-dealer has actual or *de facto* control over a retail account. As described in Section IV.B above,

aggregate costs and burdens imposed on broker-dealers by the record-making obligation of proposed Rule 17a-3(a)(25) and the recordkeeping obligation of the proposed amendment to Rule 17a-4(e)(5) associated with all component obligations of the proposed Regulation Best Interest. The estimate of the initial aggregate burden is based on the following calculation: 4,110 hours + 3,808,000 hours + 15,866,667 hours = 19,678,777 hours, where, as discussed in more detail in Section V.D, 4,110 hours is the preliminary estimate of amending the account disclosure agreement by large broker-dealers, 3,808,000 hours is the preliminary estimate of the burden associated with filling out the information disclosed pursuant to Regulation Best Interest in the account disclosure agreement, and 15,866,667 hours is the preliminary estimate of the burden to broker-dealers for adding new documents or modifying existing documents to the broker-dealer's existing retention system. \$378,544 is the preliminary estimate of amending the account disclosure agreement by small broker-dealers pursuant to the record-making obligation of proposed Rule 17a-3(a)(25). 3,173,334 hours is the preliminary estimate of the ongoing aggregate annual burden to broker-dealers of complying with the recordkeeping obligation of the proposed amendment to Rule 17a-4(e)(5).

<sup>481</sup> These estimates are calculated as follows: (2,055 hours of in-house legal counsel) × (\$409.37/hour for in-house counsel) + (19,674,667 hours for entering and adding new or modifying existing documents in each customer account) × (\$229.46/hour for registered representative) + (2,055 hours for in-house compliance counsel) × (\$359.81/hour for in-house compliance counsel) + (802 hours for outside legal counsel) × (\$472/hour for outside legal counsel) = \$4,516.56 million, and (3,173,334 hours for record keeping) × (\$229.46/hour for registered representative) = \$1,141.81 million. The hourly wages for in-house legal and compliance counsel and registered representatives are obtained from SIFMA. The hourly rates for outside legal counsel are discussed in Section V.D.

existing suitability rules require that a broker-dealer or associated person have a reasonable basis to believe that a recommendation or investment strategy is “suitable” for the retail customer.<sup>482</sup> Suitability depends, among other things, on information obtained by the broker-dealer or associated person about the retail customer’s investment profile (e.g., age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, need for liquidity, and risk tolerance).<sup>483</sup> In particular, pursuant to the requirements of FINRA’s suitability rule, currently, broker-dealers are expected to make efforts to ascertain the potential risk and rewards associated with a recommendation, given a customer’s investment profile, and to determine whether the recommendation could be in suitable for at least some retail customers. Furthermore, broker-dealers are expected to evaluate the information in a retail customer’s investment profile and other relevant information when determining whether a recommendation is suitable or whether a series of recommendations is suitable and not excessive.

Under FINRA’s suitability rule and other applicable legal standards, broker-dealers are also expected to make an effort to ascertain relevant information about a retail customer’s investment profile prior to making a recommendation on an “as needed” basis. In general, the reasonableness of a broker-dealer’s effort to collect information regarding a customer’s investment profile information depends on the facts and circumstances of a given situation.<sup>484</sup> We understand that currently broker-dealers collect information relevant to a customer’s investment profile at the inception of the relationship with the retail customer through the use of a questionnaire, such as in an account opening agreement, and during the relationship on an “as needed” basis.

The requirements of the Care Obligation of proposed Regulation Best Interest mirror closely but are not identical to the current broker-dealer practices pursuant to the requirements of FINRA’s suitability rule and other applicable legal standards. The first important difference is the requirement that broker-dealers have a reasonable basis to believe that a recommendation is in the best interest of a retail customer and that a series of recommendations is not excessive and in the best interest of

the retail customer. The suitability standard does not have an explicit best interest requirement and therefore broker-dealers may be able to make recommendations today that, while suitable, may not meet the Care Obligation proposed as part of Regulation Best Interest. As noted above, to the extent that current broker-dealer practices pursuant to the requirements of FINRA’s suitability rule do not reflect the proposed best interest standard of conduct, the Care Obligation would impose a cost on broker-dealers. The other important difference is the removal of the element of control from the requirement to have a reasonable basis to believe that a series of recommendations is not excessive and in the best interest of the retail customer. As noted above, unlike the quantitative suitability requirement of FINRA’s suitability rule, this requirement of the Care Obligation applies irrespective of whether a broker-dealer has actual or *de facto* control over the account of the retail customer. To the extent that the removal of the element of control may cause a potential increase in retail customer arbitrations, the Care Obligation would impose a cost on broker-dealers due to enhanced legal exposure.<sup>485</sup>

As noted earlier, the proposed rule would also amend Exchange Act Rule 17a-4(e)(5) to require broker-dealers to retain any customer information that the customer would provide to the broker-dealer pursuant to Regulation Best Interest, as well as copies of any conflict disclosures provided to the customer by the broker-dealer pursuant to Regulation Best Interest, in addition to the existing requirement to retain information obtained pursuant to Exchange Act Rule 17a-3(a)(17). Furthermore, broker-dealers would be required to retain all of the retail customer investment profile information that they would obtain as well as copies of conflict disclosures they would provide for six years. Currently, under Rule 17a-3(a)(17), broker-dealers that make recommendations for accounts with a natural person as customer or owner are required to create, and periodically update, specified customer account information. However, the information collection requirements of Rule 17a-3(a)(17) do not cover all aspects of “customer investment profile” that broker-dealers may attempt to obtain to make a customer-specific suitability determination under FINRA’s suitability rule. To the extent that a retail customer would provide a broker-dealer with information about the customer’s

investment profile pursuant to either FINRA’s suitability rule or Regulation Best Interest, the proposed rule would require that broker-dealers retain that information for six years. However, since the Care Obligation of proposed Regulation Best Interest has no record-making requirement with respect to information that broker-dealers obtain from retail customers, the Commission believes that the costs to the broker-dealers of the retention requirement to be small.

The Care Obligation may also impose costs on retail customers, to the extent that broker-dealers pass on costs to their retail customers. The Commission is unable to fully quantify the size of these costs due to a number of factors. First, while the FINRA suitability standard does not explicitly prohibit a broker-dealer from putting its interest ahead of the customer’s, FINRA’s interpretation suggests that a broker-dealer may not put its interest ahead of the customer’s.<sup>486</sup> Second, it is unclear whether or to what extent the adoption of Regulation Best Interest would affect the number of retail customer arbitrations, since many retail customer arbitrations are already predicated on facts alleging that a broker-dealer breached a fiduciary duty or breached its suitability obligations.<sup>487</sup> Finally, the portion of the costs that broker-dealers may pass on to retail customers may depend on the costs that a retail customer would incur to switch from one broker-dealer to another or from a broker-dealer to an investment adviser. While a range of estimates for the costs of the Care Obligation may be difficult to obtain due to the potentially wide range of assumptions about these factors, preliminary estimates for the portion of these costs borne by broker-dealers may be obtained under specific assumptions. For instance, the Commission believes that, with respect to the Care Obligation, the record-making obligation of proposed Rule 17a-3(a)(25) and the recordkeeping obligation of the proposed amendment to Rule 17a-4(e)(5) would involve creating new documents or modifying existing documents to reflect standardized questionnaires seeking customer investment profile information. The costs associated with the record-making and recordkeeping obligations are discussed in Section IV.D.2.b above, and in more detail in Section V.D below.

<sup>482</sup> See *supra* note 431.

<sup>483</sup> See *supra* note 241.

<sup>484</sup> See FINRA Regulatory Notice 12-25 at Q16.

<sup>485</sup> See *infra* note 511.

<sup>486</sup> See Rule 2111, FAQ—Q7.1, available at <http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq>.

<sup>487</sup> See *supra* note 475 and accompanying text.

d. Obligation To Establish, Maintain, and Enforce Written Policies and Procedures Reasonably Designed To Identify and at a Minimum Disclose, or Eliminate, All Material Conflicts of Interest Associated With a Recommendation

As noted above, proposed Regulation Best Interest would require broker-dealers to comply with two Conflict of Interest Obligations. The first of these obligations would require a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with a recommendation.<sup>488</sup> These conflicts may arise for a number of reasons. For example, a broker-dealer may be in a position to recommend: Proprietary products, products of affiliates, or limited range of products; one share class versus another share class of a mutual fund; securities underwritten by the firm or a broker-dealer affiliate; the rollover or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA, when the recommendation involves a securities transaction); and allocation of investment opportunities among retail customers. Broker-dealers would also need to consider whether these conflicts arise from financial incentives and therefore are subject to the additional Conflict of Interest Obligation to establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with a recommendation that is discussed in more detail below.

Before determining whether to satisfy this Conflict of Interest Obligation by disclosing, or eliminating, all material conflicts of interest associated with a recommendation, broker-dealers would have to first identify such material conflicts. To this end, the obligation would require that broker-dealers establish written policies and procedures reasonably designed to identify material conflicts of interest. In particular, these policies and

<sup>488</sup> As discussed in Section I.B above, one key difference and enhancement resulting from the obligations imposed by Regulation Best Interest, as compared to a broker-dealer's existing suitability obligations under the antifraud provisions of the federal securities laws, is that the antifraud provisions require an element of fraud or deceit, which would not be required under Regulation Best Interest. More specifically, the Care Obligation could not be satisfied by disclosure.

procedures would be expected to identify a conflict in a manner that is relevant to a broker-dealer's business practice, identify which conflicts arises from financial incentives, provide a structure for identifying new conflicts as broker-dealers' business practices evolve, and provide a structure for an ongoing review for the identification of conflicts relevant to current business practices.

Once the broker-dealer identifies a material conflict of interest associated with a recommendation, the obligation requires that broker-dealers establish written policies and procedures reasonably designed to at a minimum disclose, or eliminate, the identified material conflict of interest. In addition, reasonably designed policies and procedures would likely include a discussion regarding the delivery of a Relationship Summary, Regulatory Status Disclosure, or other standardized documentation developed to disclose material conflicts of interest to the retail customer. The Commission preliminarily believes that such policies and procedures would provide a structure for effectively addressing new or existing material conflicts of interest that are relevant to a recommendation.

If a broker-dealer determines to satisfy the obligation through disclosure, the broker-dealer would be expected to provide the retail customer, in writing, with sufficiently specific facts so that the customer is able to understand the conflicts of interest a broker-dealer has and can make an informed decision about a recommended transaction or strategy. As noted above, proposed Regulation Best Interest would provide broker-dealers with flexibility in determining the most appropriate way to meet their disclosure obligation in a manner consistent with their business practices.

If a broker-dealer determines to satisfy the obligation by eliminating an identified material conflict of interest, the broker-dealer would be expected to, for instance, remove any incentives associated with recommending a particular product or service, not offer products that come with associated incentives, or negate the effect of the conflict. The effects of this obligation on broker-dealers and their retail customers are discussed in more detail below.

In addition to the requirement that broker-dealers establish written policies and procedures to identify and at a minimum disclose, or eliminate, material conflicts of interest, the obligation would also require that broker-dealers maintain and enforce such policies and procedures. Toward that end, broker-dealers would be

expected to develop risk-based compliance and supervisory systems that promote compliance with proposed Regulation Best Interest consistent with their business practices and in a manner that focuses on areas of those business practices that pose risks of violating the Conflict of Interest Obligations. Broker-dealers are currently subject to supervisory obligations under Section 15(b)(4)(E) of the Exchange Act and SRO rules, including the establishment of policies and procedures reasonably designed to prevent and detect violations of, and to achieve compliance with, the federal securities laws and regulations, as well as applicable SRO rules.<sup>489</sup> Consequently, in order to comply with the requirement to maintain and enforce the policies and procedures pursuant to the requirement to establish such policies and procedures of the Conflict of Interest Obligation, broker-dealers could adjust their current systems of supervision and compliance, as opposed to creating new systems.

The requirement to establish, maintain, and enforce written policies and procedures to identify and at a minimum disclose, or eliminate, material conflicts of interest would impose initial and ongoing costs and burdens on broker-dealers. As discussed in more detail in Section V.D., the Commission preliminarily believes that broker-dealers would update their policies and procedures to comply with this requirement and would incur an initial aggregate burden of 131,320 hours and an additional initial aggregate cost of approximately \$24.84 million, as well as an ongoing aggregate annualized burden of 28,670 hours, and an ongoing aggregate annualized cost of approximately \$3.08 million.<sup>490</sup> Furthermore, the Commission preliminarily believes that in order to identify conflicts of interest and determine whether the conflicts are material, broker-dealers would incur an

<sup>489</sup> See FINRA Rule 3110 (Supervision) (requiring firms to establish and maintain systems to supervise the activities of their associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules).

<sup>490</sup> These estimates are based on the following calculations: 123,300 hours + 8,020 hours = 131,320 hours; \$9.7 million + \$15.1 million = \$24.8 million; and 24,660 hours + 4,010 hours = 28,670 hours. As discussed in more detail in Section V.D, 123,300 hours and 8,020 hours are preliminary estimates for the initial aggregate burdens for large and small broker-dealers, respectively, \$9.7 million and \$15.1 million are preliminary estimates for the initial aggregate costs for large and small broker-dealers, respectively, and 24,660 hours and 4,010 hours are preliminary estimates for the ongoing aggregate burdens for large and small broker-dealers, respectively.

initial aggregate burden of 28,570 hours and an additional initial aggregate cost of approximately \$15.43 million as well as an ongoing aggregate annualized burden of 28,570 hours.<sup>491</sup> Finally, the Commission preliminarily believes that in order to maintain and enforce written policies pursuant to the obligation to identify and at the minimum disclose, or eliminate, material conflicts of interest broker-dealers would incur an initial aggregate burden of 446,499 hours and an additional initial aggregate cost of approximately \$61.71 million as well as an ongoing aggregate annualized burden of 435,071 hours.<sup>492</sup> Thus, the Conflict of Interest Obligation of proposed Regulation Best Interest would impose an initial aggregate cost of at least \$273.01 million and an ongoing aggregate annual cost of at least \$120.92 million on broker-dealers.<sup>493</sup>

<sup>491</sup> The estimate of the initial aggregate burden is based on the following calculations: 14,285 hours + 14,285 hours = 28,570 hours, where, as discussed in more detail in Section V.D, 14,285 hours and 14,285 hours are preliminary estimates for the initial aggregate burdens for identifying conflicts of interest and determining whether the conflicts are material for all broker-dealers, respectively.

<sup>492</sup> The estimate of the initial aggregate burden is based on the following calculations: 11,428 hours + 435,071 hours = 446,499 hours, where, as discussed in more detail in Section V.D, 11,428 hours and 435,071 hours are preliminary estimates for the initial aggregate burdens of approving training modules and training of registered representatives for all broker-dealers, respectively.

<sup>493</sup> These estimates are calculated as follows: (106,209 hours of in-house legal counsel) × (\$409.37/hour for in-house counsel) + (435,071 hours for training) × (\$229.46/hour for registered representative) + (27,692.5 hours for in-house compliance counsel) × (\$359.81/hour for in-house compliance counsel) + (7,142.5 hours for determining if identified conflicts of interest are material) × (\$270.40/hour for senior business analyst) + (30,274 hours for review of policies and procedures) × (\$522.49/hour for compliance manager) + (52,630 hours for outside legal counsel) × (\$472/hour for outside legal counsel) + (57,140 hours for modifying existing technology) × (\$270/hour for outside senior programmer) + (228,560 hours for updating training module) × (\$270/hour for systems analyst or programmer) = \$273.01 million, and (8,220 hours of in-house legal counsel) × (\$409.37/hour for in-house counsel) + (435,071 hours for training) × (\$229.46/hour for registered representative) + (26,515 hours for in-house compliance counsel) × (\$359.81/hour for in-house compliance counsel) + (25,505 hours for identifying conflicts of interest) × (\$226.23/hour for business-line personnel) + (30,274 hours for review of policies and procedures) × (\$522.49/hour for compliance manager) + (4,010 hours for outside legal counsel) × (\$472/hour for outside legal counsel) + (4,010 hours for outside compliance services) × (\$298/hour for outside compliance services) = \$120.92 million. The hourly wages for in-house legal and compliance counsel, registered representatives, senior business analyst, compliance manager, and business-line personnel are obtained from SIFMA. The hourly rates for outside legal counsel, outside senior programmer, systems analyst or programmer and outside compliance services are discussed in Section V.D.

#### (1) Eliminate Material Conflicts of Interest Associated With a Recommendation

Broker-dealers may offer a wide variety of dealer services and products to retail customers. Under the Exchange Act, a “dealer” is defined as “any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person’s own account through a broker or otherwise.”<sup>494</sup> Dealer activity may include, but is not limited to, selling securities (such as bonds) out of inventory; buying securities from customers; selling proprietary products (e.g., products such as affiliated mutual funds, structured products, private equity and other alternative investments); selling initial and follow-on public offerings; selling other underwritten offerings; acting as principal in Individual Retirement Accounts; acting as a market maker or specialist on an organized exchange or trading system; acting as a *de facto* market maker or liquidity provider; and otherwise holding oneself out as buying or selling securities on a continuous basis at a regular place of business.

In all of these instances broker-dealers transact with their customers as principals. As discussed above, when a broker-dealer makes a recommendation to a retail customer that involves products or services associated with its dealer activities, the recommendation would be subject to a conflict of interest. The Conflict of Interest Obligations would require that broker-dealers establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose (and mitigate when financial incentives are involved), or eliminate such conflicts of interest that are material.

If a broker-dealer determines to comply with the Conflict of Interest Obligations by eliminating material conflicts of interest associated with recommendations on products or services on which the broker-dealer acts as a dealer, the broker-dealer would be expected to, for instance, remove any incentives associated with recommending such products or services, not offer products that come with associated incentives, or negate the effect of the conflict. For instance, the broker-dealer may choose to no longer recommend such products or services or continue to make such recommendations but effectuate the

transactions in a way that does not involve a principal trade.

Eliminating this type of conflict of interest may have an impact on broker-dealers’ revenue and may reduce the set of securities transactions recommended by a broker-dealer; or it may alter the specific securities transactions that a broker-dealer recommends or the manner and cost and quality of execution (e.g., because a broker-dealer places an order with a third-party market maker rather than its own proprietary trading desk). Further, dealers act as important financial market intermediaries by providing liquidity to retail customers and helping to maintain continuous and smooth price transitions for securities. If broker-dealers determine to eliminate material conflicts of interest, the resulting change to how this critical role is performed could impact market liquidity.

The costs of complying with the Conflict of Interest Obligation by eliminating material conflicts of interest related to financial incentives that arise from broker activity are discussed in a subsequent section below.

#### (2) At a Minimum Disclose Material Conflicts of Interest Associated With a Recommendation

A broker-dealer would have to establish, maintain, and enforce written policies and procedures that are reasonably designed to at a minimum disclose those material conflicts of interest that the broker-dealer does not determine to eliminate.

As described in Section IV.B above, when making a recommendation, broker-dealers are subject to a number of disclosure requirements under current Commission antifraud obligations, Exchange Act rules, and FINRA rules. Also, as described in Sections I.A and IV.B above, when engaging in transactions directly with customers on a principal basis, a broker-dealer violates Exchange Act Rule 10b–5 when it knowingly or recklessly sells a security to a customer at a price not reasonably related to the prevailing market price and charges excessive markups, without disclosing the fact to the customer. Exchange Act Rule 10b–10 also requires a broker-dealer effecting transactions in securities to provide written notice to the customer of certain information specific to the transaction at or before the completion of the transaction, including the capacity in which the broker-dealer is acting (*i.e.*, agent or principal).<sup>495</sup>

<sup>495</sup> See Rule 10b–10. Rule 10b–10 requires a broker-dealer effecting customer transactions in

<sup>494</sup> Section 3(a)(5)(A) of the Exchange Act.



The Commission believes that policies and procedures would likely include instructions for a broker-dealer to determine whether a material conflict of interest, once identified, would need to be disclosed.

As noted above, Regulation Best Interest would not prescribe the process by which broker-dealers should disclose all material conflicts of interest to their retail customers. Instead, the proposed rule would give broker-dealers flexibility in identifying the most efficient and effective way of complying with the disclosure obligation that is consistent with a broker-dealer's business practice. Furthermore, although the obligation to disclose material conflicts of interest may impose costs on broker-dealers, the Commission preliminarily believes that permitting disclosure instead of outright elimination of material conflicts may reduce the costs the overall best interest obligation could impose on retail customers. This is because the disclosure alternative may preserve access to any recommendations that retail customers currently might find beneficial, even taking into account the existence of material conflicts.

Broker-dealers that currently employ minimal disclosure practices that comply with the current disclosure requirements under federal securities laws and applicable SRO rules about material conflicts of interest with respect to their recommendations may incur higher costs of complying with this enhanced disclosure obligation.

The Commission is unable to fully quantify these costs due to a number of factors. First, the Commission lacks data that quantifies how different current disclosure practices are compared to where they should be to comply with the disclosure obligation with respect to conflicts of interest. Second, given that the proposed rule allows broker-dealers flexibility in complying with the disclosure obligation, there could be multiple ways in which broker-dealers could satisfy this obligation. While a range of estimates for the costs of disclosure obligation with respect to conflicts of interest may be difficult to obtain due to the potentially wide range of assumptions about these factors, preliminary estimates for the portion of

securities (other than U.S. savings bonds or municipal securities) to provide written notification to the customer, at or before completion of the transaction, disclosing information specific to the transaction, including whether the broker-dealer is acting as agent or principal and its compensation, as well as any third-party remuneration it has received or will receive. *See also* NASD Rule 2340 (Customer Account Statements) (broker-dealers must provide customer account statements on at least a quarterly basis).

these costs borne by broker-dealers may be obtained under specific assumptions. These latter costs are discussed in Section IV.D.2.b above and in more detail in Section V.D. below.

e. **Obligation To Establish, Maintain, and Enforce Written Policies and Procedures Reasonably Designed To Identify and Disclose and Mitigate, or Eliminate, Material Conflicts of Interest Arising From Financial Incentives Associated With a Recommendation**

Proposed Regulation Best Interest also includes the additional requirement that a broker, dealer, or associated person establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with a recommendation.

As noted above, we would interpret a material conflict of interest arising from financial incentives to include the structure of fees and other charges for the services provided and products sold; employee compensation or employment incentives (*e.g.*, quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); and compensation practices involving third-parties, such as sales compensation and compensation for services provided to third-parties or to retail customers on behalf of third parties (*e.g.*, sub-accounting or administrative services provided to a mutual fund). In particular, financial incentives that create material conflicts of interest from financial incentives may include, for example, differential or variable compensation received by the broker-dealer itself (but not an affiliate), whether paid by the retail customer or a third-party; receipt of fees, commissions or other charges on sales of proprietary products, and transactions on a principal basis.

Broker-dealers may consider establishing policies and procedures like the following to fulfill the Conflict of Interest Obligation: Policies and procedures outlining how the firm identifies its material conflicts (and material conflicts arising from financial incentives), including such material conflicts of natural persons associated with the broker-dealer, clearly identifying all such material conflicts of interest and specifying how the broker-dealer intends to address each conflict; robust compliance review and monitoring systems; processes to escalate identified instances of noncompliance to appropriate personnel for remediation; procedures

that clearly designate responsibility to business lines personnel for supervision of functions and persons, including determination of compensation; processes for escalating conflicts of interest; processes for a periodic review and testing of the adequacy and effectiveness of policies and procedures; and training on the policies and procedures. Furthermore, as noted above, such policies and procedures would be expected to provide a structure for effectively addressing new or existing material conflicts of interest that arise from financial incentives associated with a recommendation, including whether to disclose and mitigate or eliminate such a conflict. Finally, in order to enforce such policies and procedures, and consistent with the discussion above, broker-dealers may determine that it is necessary to modify their current supervisory systems or develop new ones.

The requirement to establish, maintain, and enforce written policies pursuant to the requirement to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives of the Conflict of Interest Obligations would impose costs on broker-dealers. These costs are discussed in Section IV.D.2.d above and in more detail in Section V.D. below.

#### (1) Eliminate Material Conflicts Arising From Financial Incentives Associated With a Recommendation

For some broker-dealers, compensation arrangements with product-sponsoring third parties may be an important source of revenue. For instance, as described in Section IV.B, sales of investment company products range on average between 8 percent and 20 percent of broker-dealer revenue, depending on the size of the broker-dealer. Some (but not necessarily all) of these products are subject to compensation arrangements between broker-dealers and third parties that are sponsoring these products. As noted above, when making recommendations to retail customers on products that are subject to compensation arrangements, a broker-dealer has a financial incentive, and therefore a conflict of interest. The Conflict of Interest Obligations would require that the broker-dealer establish, maintain, and enforce written policies that are reasonably designed to identify and disclose and mitigate, or eliminate this type of conflict of interest. If a broker-dealer were to determine to eliminate this conflict, the broker-dealer would have to take actions that would negate the existence of the conflict in the first place. For instance, the broker-dealer could credit retail customers all

the compensation it receives from product sponsors when recommending their products to retail customers. Alternatively, the broker-dealer could stop providing recommendations to retail customers on products that are subject to compensation arrangements. In both cases, the broker-dealer would forgo all the revenues tied to compensation paid by product sponsors for distributing their products to retail customers.

More generally, broker-dealers that determine to eliminate conflicts of interest arising from financial incentives may lose up to the entire revenue stream associated with recommending products that are subject to compensation arrangements. However, to the extent that eliminating the conflict of interest arising from financial incentives causes broker-dealers to offer only products that are no longer subject to this type of conflict, the revenue stream generated by these products would offset some of the revenue loss associated with products no longer recommended. Furthermore, to the extent that broker-dealers that chose to eliminate this conflict would limit their recommendations on products subject to compensation arrangements, retail customers would no longer have access to the same advice. The Commission preliminarily believes that the cost to broker-dealers of eliminating conflicts of interest arising from financial incentives could be large. As noted earlier, investment company products account currently for a significant portion of broker-dealers' revenues. However, only a portion of such revenues come from recommendations that broker-dealers make on investment company products to retail customers. Since the Commission lacks data at this level of granularity, the Commission is unable to quantify the magnitude of the potential revenue loss from eliminating conflicts of interest associated with financial incentives. Similarly, for reasons that include the aforementioned data limitation and the difficulty in quantifying how retail customers value broker-dealer advice (*e.g.*, as discussed earlier, the value of broker-dealer advice to retail customers would depend on how retail customers generally perceive the risk and return of their portfolio, the likelihood of acting on a recommendation that complies with the best interest obligation, and, ultimately, how the risk and return of their portfolio change as a result of how they act on the recommendation), the Commission is unable to quantify the magnitude of the cost to retail customers of no longer having access to the advice.

In addition to conflicts of interest arising from financial incentives, broker-dealers also may be subject to conflicts of interest associated with internal compensation structures that may give rise to financial incentives to registered representatives. Much as there is an agency relationship between retail customers and broker-dealers, there is an agency relationship between broker-dealers and registered representatives. Broker-dealer and registered representative incentives may not be perfectly aligned. Like any agency relationship, contracts can be structured in such a way as to better align the incentives of the broker-dealer and its registered representatives. For example, broker-dealers may offer registered representatives compensation structures that reward them based on the amount of revenues they bring in from providing services, including advice. Such compensation structures are designed to benefit both the broker-dealers and the registered representatives by motivating greater effort by registered representatives. If a broker-dealer were to eliminate the use of compensation structures that motivate effort by registered representatives, its revenues would likely decline unless offset by replacement revenue streams. At the same time, the agency costs associated with the relationship between a broker-dealer and its registered representatives could increase to the point where such a relationship may not be justified going forward. In particular, a registered representative at a standalone broker-dealer may determine to terminate his or her relationship with the broker-dealer, while a registered representative at a dual-registrant may determine to offer advice only in a capacity of investment adviser. Such dynamics would have a negative impact on the supply of broker-dealer recommendations, which, in turn, would limit retail customer access to broker-dealer advice.

Given these considerations, we preliminarily believe that the costs associated with eliminating material conflicts of interest associated with compensation structures could be large for both broker-dealers and retail customers. However, the Commission is unable to fully quantify the magnitude of such costs due to a number of factors. First, the cost to broker-dealers would depend on determinants such as the extent to which internal compensation structures reward registered representatives for generating revenues and the sensitivity of broker-dealer revenues to elements of the registered

representatives' compensation contract that rewards them for generating revenue (*e.g.*, the portion of commission that they can retain). Currently, the Commission has data only on the former determinant—as described in Section IV.C—and lacks data on the second determinant. Second, the cost to retail customers would depend on determinants such as how retail customers perceive the risks and returns of their portfolios, the likelihood of acting on a recommendation that complies with the best interest obligation, and how those risk and returns change as a result of a decline or change in the supply of broker-dealer recommendations. While a range of estimates for these costs may be difficult to obtain due to the potentially wide range of assumptions about these factors, preliminary estimates for the portion of these costs borne by broker-dealers may be obtained under specific assumptions. For instance, the Commission preliminarily believes that reasonably designed policies and procedures should establish a clearly defined process for determining how to address any identified material conflict of interest, including whether and how to eliminate a material conflict of interest arising from financial incentives. The costs associated with establishing, maintaining and enforcing such policies are discussed in Section IV.D.2.d above and in more detail in Section V.D below.

#### (2) Disclose and Mitigate Material Conflicts of Interest Arising From Financial Incentives Associated With a Recommendation

As noted earlier, when providing recommendations, broker-dealers potentially are liable under the federal securities laws' antifraud provisions if they do not give "honest and complete information" or disclose all material adverse facts and material conflicts of interest, including economic self-interest, in connection with a recommendation. The disclosure obligations for broker-dealer material conflicts of interest—including conflicts related to financial incentives—under Regulation Best Interest would go beyond the existing disclosure requirements and liabilities. Namely, a broker-dealer making a recommendation to a retail customer would be expected to provide the retail customer with sufficiently specific facts about any material conflicts of interest arising from financial incentives associated with the recommendation such that the retail customer would be able to understand the conflict and make an

informed decision about the recommendation.

A broker-dealer would have to establish, maintain, and enforce written policies and procedures that are reasonably designed to disclose and mitigate those material conflicts of interest arising from financial incentives that the broker-dealer does not determine to eliminate. The Commission expects that such policies and procedures would include instructions for a broker-dealer to determine whether a material conflict of interest, once identified, would need to be disclosed and mitigated.

The requirement to establish, maintain, and enforce written policies and procedures that are reasonably designed to disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives of the Conflict of Interest Obligations would impose costs on broker-dealers. Broker-dealers that currently engage in disclosure practices that are closer to the disclosure obligation of the proposed rule would likely incur lower costs of complying with this obligation. However, as noted above, Regulation Best Interest would provide broker-dealers with flexibility in determining the most appropriate way to meet this disclosure obligation, consistent with each broker-dealer's business practices.

Similar to the discussion above about the disclosure obligation with respect to all conflicts of interest, the Commission is unable to fully quantify the costs associated with this obligation due to two factors. First, the Commission lacks data that quantifies how different current disclosure practices are compared to where they should be to comply with the disclosure obligation with respect to conflicts of interest arising from financial incentives. Second, given that the proposed rule allows broker-dealers flexibility in complying with this disclosure obligation, there could be multiple ways in which broker-dealers could satisfy this obligation. While a range of estimates for the costs of disclosure obligation may be difficult to obtain due to the potentially wide range of assumptions about these factors, preliminary estimates for the portion of these costs borne by broker-dealers may be obtained under specific assumptions. These latter costs are discussed in Section IV.D.2.b above and in more detail in Section V.D below.

In addition to the disclosure obligation, the Conflict of Interest Obligations of Regulation Best Interest would also require that broker-dealers to establish, maintain, and enforce policies and procedures to mitigate conflicts of

interest related to financial incentives—including conflicts arising from internal compensation structures and compensation arrangements with product sponsors. The costs that broker-dealers would potentially incur to comply with this new requirement depends on what may constitute reasonable mitigation. The proposed rule does not stipulate specific conflict mitigation measures. Instead, the Commission's proposal would give broker-dealers flexibility to develop and tailor policies and procedures aimed at conflict mitigation measures based on each firm's business practices (such as the size of the firm, retail customer base, the nature and significance of the compensation conflict, and the complexity of the product).

Some conflicts of interest related to financial incentives arise from internal compensation structures. As discussed above, the Commission preliminarily believes that the costs to broker-dealers from eliminating material conflicts of interest associated with compensation structures could be large. As an alternative, broker-dealers could retain the compensation structures to address the incentive conflict between the broker-dealers and registered representatives, while taking actions to mitigate the material conflict of interest that those structures may create between broker-dealers or registered representatives and retail customers.

Certain aspects of the market for brokerage services may serve, on their own, to mitigate, to some extent, conflicts of interest between broker-dealers and retail customers that may arise from compensation structures. Potential legal liability and reputational risk related to unsuitable recommendations can serve as a motivation to ameliorate the conflict between broker-dealer representatives and customers. Concerned about their potential legal liability as well as their reputations, many broker-dealers currently take actions to ameliorate conflicts.<sup>496</sup> For example, some broker-dealers may use "product agnostic" compensation structures (also referred to as "neutral grids") that reduce a registered representative's incentive to recommend one type of product over another.<sup>497</sup> Broker-dealers can also cap the credit a registered representative receives for selling comparable products, thereby reducing the registered representative's incentive to prefer, for example, one mutual fund or

variable annuity over another.<sup>498</sup> Further, broker-dealers can impose compensation adjustments on registered representatives who do not properly manage material conflicts of interest.<sup>499</sup> Another mechanism for mitigating the conflict between registered representatives and customers is for broker-dealers to link surveillance of registered representatives' recommendations, and potential compensation adjustments, to thresholds in a firm's compensation structure to deter recommendations that may be motivated by a desire to receive higher compensation.<sup>500</sup> A number of firms also perform specialized supervision and surveillance of recommendations, which could result in compensation adjustments, as a registered representative approaches the end of the period over which performance is measured for receiving bonuses.<sup>501</sup> Finally, a number of firms perform additional surveillance which could result in compensation adjustments when a registered representative approaches the threshold necessary for admission to a firm recognition club.<sup>502</sup>

As noted above, proposed Regulation Best Interest would give broker-dealers the flexibility to develop and tailor individual conflict mitigating measures based on their business practices. The cost of mitigating material conflicts associated with financial incentives will depend, among other things, upon the extent to which broker-dealers are currently engaging in conflict mitigating activities. As discussed above, FINRA's 2013 study of conflicts states that a number of firms are already engaging to various degrees in some of those activities.<sup>503</sup> For those firms that currently engage to a larger extent in conflict mitigating activities, we would expect that the costs associated with the Conflict of Interest Obligations of the proposed rule to be lower. However, the Commission is currently unable to quantify the magnitude of the costs to broker-dealers for complying with the Conflict of Interest Obligation to mitigate material conflicts of interest related to financial incentives, as applied to internal compensation structures, for a number of reasons.

<sup>498</sup> *Id.*

<sup>499</sup> *Id.*

<sup>500</sup> *Id.*

<sup>501</sup> *Id.*

<sup>502</sup> *Id.*

<sup>503</sup> *Id.* The FINRA study notes that its observations are drawn from discussions with large firms. As a result, FINRA notes that the findings of the study will not in all cases be directly applicable to small firms. See FINRA Report on Conflicts of Interest at p. 2.

<sup>496</sup> See FINRA Report on Conflicts of Interest (Oct. 2013), at 6, available at <http://www.finra.org/sites/default/files/Industry/p359971.pdf>.

<sup>497</sup> *Id.*

First, the Commission lacks data that quantifies the costs of firms engaging in conflict mitigating activities. Second, given that the proposed rule allows broker-dealers to tailor their conflict mitigating measures to their business practices, there could be multiple ways in which broker-dealers could address the conflict mitigating aspect of the Conflict of Interest Obligation. Finally, any estimate of the magnitude of such costs would depend on assumptions about the extent to which broker-dealers are currently engaging in conflict mitigating activities and how broker-dealers would choose to satisfy the Conflict of Interest Obligation with respect to conflicts of interest arising from internal compensation structures. Because the Commission lacks the data that would help narrow the scope of these assumptions, the resulting range of potential estimates would be wide, and, therefore, may not be informative (in a statistical sense) about the magnitude of the costs associated with mitigating conflicts of interest arising from internal compensation structures.

Conflicts of interest related to financial incentives may also arise from financial arrangements between broker-dealers and product sponsors. Furthermore, as discussed above, the Commission preliminarily believes that the costs to broker-dealers from eliminating material conflicts of interest associated with financial incentives could be large. As an alternative, broker-dealers may determine not to eliminate a conflict and instead to mitigate it. To comply with the Conflict of Interest Obligations of the proposed rule, broker-dealers that offer recommendations to retail customers based on products subject to agreement with product sponsors would have to adopt conflict mitigation measures that would reasonably meet these obligations. As noted earlier, the proposed rule does not explicitly specify mandatory conflict mitigation measures. Instead, the rule would give broker-dealers flexibility to develop and tailor conflict mitigation measures consistent with their business practices.

Some broker-dealers may determine to eliminate the most expensive products. For instance, broker-dealers may perceive that the monitoring costs of ensuring that their registered representatives act in the retail customer's best interest when making recommendations based on the full set of offered products (including the most and least expensive products) may be too large. It is possible that such an approach, which eliminates products based on cost alone, may result in a broker-dealer not making available

products that, while being more expensive, may provide better performance than products that are still offered. Thus, conflict mitigating measures that constrain the set of products offered may limit retail customer choice and, therefore, may impose a cost on retail customers. Furthermore, these conflict mitigating measures may impact the way registered representatives get compensated, and, therefore, may alter their incentives to expend effort (e.g., to understand the product and the customer that would best fit the product) in providing recommendations of higher quality. The potential change in the level of effort that registered representatives expend when making recommendations may alter the quality of advice that retail customers receive, which, in turn, may impose a cost on retail customers. Alternatively, some broker-dealers may determine to reduce the set of offered products in each product class by eliminating those products that are the least expensive, or by eliminating both the most and the least expensive. This approach would result in a set of products that would be more homogeneously priced, in order to comply with the mitigation aspect of the Conflict of Interest Obligations. However, like the approach above, this approach may also limit retail customer choice, and, therefore, may impose a cost on retail customers.

More generally, the use of tailored products by broker-dealers to mitigate conflicts of interest arising from financial incentives may introduce additional complexities that could ultimately increase the costs borne by retail customers. Therefore, there may be circumstances where broker-dealers determine that eliminating rather than mitigating conflicts through the use of products would be more advantageous for the retail customer.

The factors that would affect a broker-dealer's choice to either eliminate or mitigate conflicts are likely to vary. One example involving the range of considerations that would need to be taken into account is the use of "clean" shares, launched recently by a number of mutual fund families. Clean shares, unlike other types of mutual fund share classes, do not involve typical sales and servicing fees. Instead, broker-dealers would be able to set their own commissions which could be structured to avoid the conflicts posed by existing distribution and servicing fee structures. For instance, broker-dealers could set the commissions for these products

according to neutral factors that have been discussed earlier.<sup>504</sup>

While some broker-dealers may determine that clean shares are a potential solution to mitigating conflicts of interest arising from compensation arrangements for mutual funds, because broker-dealers could set the fee schedules according to neutral factors, retail customers purchasing clean shares could face higher costs compared to other share classes depending on the investors' holding period for the shares. For some retail customers with short time horizons, clean shares may be more costly relative to other mutual fund share classes. Moreover, due to the nature of clean shares, retail customers may not receive other benefits associated with some mutual fund share classes, such as rights of accumulation that allow investors to account for the value of previous fund purchases with the value of the current purchases. Investors also may not be able to use letters of intent for further purchases to qualify for breakpoint discounts.

In addition, broker-dealers that use clean shares may incur costs stemming from, among other things, back-office work, training of employees, reprogramming of systems, changes to compliance and desk policies and procedures, and changes to clearing procedures. In addition, while some fund complexes currently offer clean shares, not all of them do. While this trend may change in the future, broker-dealers may not be able to offer products that rely on clean shares in each product class. Further, broker-dealers may choose to incorporate clean shares into compliance systems for other commission-based products.

For broker-dealers that determine to rely on clean shares to mitigate conflicts related to financial incentives, revenues may either increase or decrease depending on the extent that the commissions charged on the clean share products are different than the overall

<sup>504</sup> Mutual fund sponsors may use different combinations of sales and servicing fees to discriminate among investors with different expected holding periods. Investors who redeem impose costs on those who remain in a fund. As a result, long-term investors may be unwilling to invest alongside investors with shorter expected holding periods. Differing sales and servicing fees can induce investors to self-select into different funds based on their expected holding period, thereby solving the long-term investors' problem of investing alongside investors with shorter expected holding periods which may, in turn, induce more investment by long-term investors. See Tarun Chordia, "The structure of mutual fund charges," *Journal of Financial Economics* (1996, vol. 41, pp. 3-39). If broker-dealers meet the conflict mitigation requirement of the proposed rule by relying on a single commission schedule, funds would not have the ability to induce investors to self-select into different funds based on expected holding period.

compensation with other funds. Furthermore, to the extent that clean shares would lead to significant changes in how broker-dealers and their associated persons would get compensated, the incentives of broker-dealers when providing advice may change. In particular, if the new compensation arrangement reduces the incentives of broker-dealers to exert effort in providing quality advice, broker-dealer recommendations could end up being of lower quality.

As noted earlier, in general, complying with the Conflict of Interest Obligations to mitigate certain material conflicts of interest may reduce broker-dealers' incentives to provide recommendations of high quality to their retail customers, and, therefore, may impose a cost on retail customers who seek advice from broker-dealers. Furthermore, certain conflict mitigation measures may be costly to implement. These implementation costs would be borne by broker-dealers, and, to the extent that they can pass on some of the costs to their retail customers, by retail customers as well.

Another way in which a broker-dealer may determine to mitigate a material conflict of interest arising from compensation arrangements with product sponsors is by expanding the set of products that the broker-dealer may recommend to a retail customer to include products that are less prone to this type of conflict of interest. That is, a broker-dealer could recommend several products that satisfy the best interest obligation and achieve the same goal (as perceived by the broker-dealer) but that differ along several dimensions, such as expected performance and the amount of compensation that the broker-dealer receives from product sponsors. Presumably, no choice in this set of suitable recommendations is strictly dominated by any of the other choices, or else some of the recommendations in this set would not be consistent with the best interest obligation. To the extent that the retail customer picks a choice in this set that happens to offer less compensation to the broker-dealer compared to the choice that the broker-dealer would have recommended under the baseline, the broker-dealer may incur some revenue loss.

The discussion above suggests that the requirement to establish, maintain, and enforce written policies and procedures to mitigate material conflicts of interest arising from financial incentives may impose costs on broker-dealers, such as potential revenue loss and costs related to the implementation of conflict mitigating measures. The

Commission is unable to quantify the magnitude of these costs for a number of reasons. First, the Commission lacks data on the extent to which current broker-dealer recommendations are subject to conflicts of interest related to financial incentives. Second, given that the proposed rule allows broker-dealers to tailor their conflict mitigating measures to their business practices, there could be multiple ways in which broker-dealers could address the conflict mitigating aspect of the Conflict of Interest Obligation. Finally, any estimate of the magnitude of such costs would depend on assumptions about the extent to which broker-dealers are currently providing retail customers with conflicted recommendations, how broker-dealers would choose to satisfy the conflict mitigating aspect of the obligation, the costs associated with implementing conflict mitigating measures, and, finally, how retail customers would respond to recommendations that reflect a given set of conflict mitigating measures. While a range of estimates for the costs of the mitigation aspect of the Conflict of Interest Obligation may be difficult to obtain due to the potentially wide range of assumptions about these factors, preliminary estimates for the portion of these costs borne by broker-dealers may be obtained under specific assumptions. For instance, the Commission preliminarily believes that reasonably designed policies and procedures should establish a clearly defined process for determining how to address any identified material conflict of interest, including whether and how to disclose and mitigate a material conflict of interest arising from financial incentives. The costs associated with establishing, maintaining, and enforcing such policies are discussed in Section IV.D.2.d.

The discussion above also suggests that the way broker-dealers choose to comply with the requirement to establish, maintain, and enforce written policies and procedures to mitigate material conflicts of interest arising from financial incentives may impose costs on retail customers. If a broker-dealer errs on the side of caution and pursues the most conservative rather than the optimal conflict mitigating measures, retail customers may end up with fewer investment choices,<sup>505</sup> and lower quality advice. For instance, if the main determinant of compensation differential across products is the level of effort it takes a broker-dealer to understand the product and the customer that would best fit the

product, conflict mitigating measures that either lead to the elimination of some of these products or that render the compensation to be less sensitive to the effort exerted by broker-dealer may reduce the investment choices available to the retail brokerage customer, and, more generally, may reduce the quality of the recommendations that a retail customer obtains from the broker-dealer. In addition, retail customers may bear some of the costs associated with broker-dealers' implementation of conflict mitigating measures.

The Commission is unable to quantify the magnitude of the costs to retail customers due to having access to potentially fewer investment choices and a potential decline in the quality of recommendations received, because such costs would depend on determinants such as how retail customers generally perceive the risk and return of their portfolio, the likelihood of acting on a recommendation that complies with the best interest obligation, and, ultimately, how the risk and return of their portfolio change as a result of how they act on the recommendation. Since the Commission lacks the data that would help narrow the scope of the assumptions regarding these determinants, the resulting range of potential estimates would be wide, and, therefore, not informative about the magnitude of the costs that the conflict mitigating aspect of the Conflict of Interest Obligation would impose on retail customers.

In addition to the potential costs imposed on broker-dealers and retail customers, the conflict mitigating aspect of the Conflict of Interest Obligations may also impose costs on product sponsors that sell their products through broker-dealers. If product sponsors rely on the broker-dealers' distribution channels to fund their products, and use compensation arrangements that create financial incentives for broker-dealers, the proposed best interest obligation may undermine those incentives and may adversely impact the funding of these products.

Specifically, broker-dealers may determine to mitigate conflicts of interest arising from financial incentives tied to compensation from product sponsors by no longer offering some of those products. These conflict mitigating measures would affect the funding of the products that are being eliminated, and therefore, the proposed rule may impose funding costs on product sponsors. The Commission is unable to quantify the magnitude of these funding costs for several reasons. First, it is difficult to identify the

<sup>505</sup> See SIFMA Study.

products that broker-dealers may no longer recommend to retail customers. Second, as noted above, there could be multiple ways in which broker-dealers could satisfy the Conflict of Interest Obligation with respect to conflicts of interest due to compensation arrangements with product sponsors. Finally, any estimate of the magnitude of such funding costs would depend on assumptions about the distribution of products across product sponsors that broker-dealers would no longer recommend to retail customers and how broker-dealers would choose to satisfy the Conflict of Interest Obligation with respect to conflicts of interest due to compensation arrangements with product sponsors. Since the Commission lacks the data that would help narrow the scope of these assumptions, the resulting range of potential estimates would be wide, and, therefore, not informative about the magnitude of the funding costs to product sponsors.

#### *D. Effects on Efficiency, Competition, and Capital Formation*

In this section, we discuss the impact that proposed Regulation Best Interest may have on efficiency, competition, and capital formation. As discussed above, the proposed rule entails both benefits and costs. The tradeoff between the benefits and costs, and the resulting effect on the gains from trade to be shared between broker-dealers and retail customers, is essential for evaluating the impact of the proposed rule on efficiency, competition, and capital formation.<sup>506</sup>

**Competition.** By establishing a best interest standard of conduct that would incorporate and expand the current broker-dealer obligations, Regulation Best Interest would ameliorate the principal-agent conflict between retail customers and broker-dealers. However, the proposed rule would impose costs on broker-dealers, retail customers and other parties with a stake in the market for financial advice, and in particular, product sponsors.

To the extent that retail customers perceive that the amelioration of the principal-agency conflict reinforces retail customers' beliefs that broker-dealers will act in their best interest, retail customers' demand for broker-dealer recommendations may increase. In turn, the potential increase in the demand for broker-dealer recommendations could lead to an

increase in the number of broker-dealers in the marketplace, and therefore to an increase in the competition among broker-dealers. An increase in competition could manifest itself in terms of better service, better pricing, or some combination of the two, for retail customers.

However, Regulation Best Interest could also have negative effects on competition. It is possible that in the process of ameliorating the agency conflict between broker-dealer and retail customers, Regulation Best Interest may impose costs on broker-dealers or retail customers that would be large enough to reduce the gains from trade shared by broker-dealers and retail customers. For instance, to the extent that the cost of the rule to broker-dealers would cause some broker-dealers to charge more for providing advice, the proposed rule may have negative competitive effects for retail customers in the form of higher pricing for advice. Similarly, to the extent that the reduction in the gains from trade causes a significant reduction in the supply of broker-dealer advice, the proposed rule may have negative competitive effects for retail customers in the form of higher prices for advice.

The reduction in the gains from trade for broker-dealers may come in the form of lower profits. In some cases, the reduction in profits may be large enough to cause some broker-dealers or their associated persons to no longer offer broker-dealer advice. In particular, the potential reduction in the profits associated with broker-dealer advice may create further incentives for some standalone broker-dealers and their associated persons to join investment advisers and, in the process, persuade their retail customers to become investment advisory clients. Similarly, some dually-registered broker-dealers may decide to only offer advice through the investment advisory side of the business or to persuade their customers to switch to advisory accounts. Regulation Best Interest may also have a differential impact on broker-dealers depending on whether they are standalone or dual-registrants. Unlike standalone broker-dealers, a dual-registrant would be able to offer advice in its capacity as an investment adviser but execute the transaction in its capacity as a broker-dealer. Because such a dual-registrant acted as a broker-dealer solely when providing execution services and not when providing advice, the dual-registrant would not be subject to the requirements of the proposed rule for its advice. Rather, the dual-registrant

would be subject to the investment advisers' fiduciary standard of care.<sup>507</sup>

If a dual-registrant would incur a larger cost of complying with the new requirements of the best interest obligation compared to the cost of complying with the requirements of the investment advisers' fiduciary standard of care and the concurrent proposed interpretation for investment advisers with respect to providing advice, the dual-registrant may have an incentive to bypass the requirements of the proposed rule by providing advice in the capacity of investment adviser, while executing transactions in the capacity of broker-dealer. To the extent that dual-registrants would engage in this practice, and to the extent that retail customers would be willing to pay for this type of advice, the magnitude of impacts from Regulation Best Interest would be lower for dual-registrants than for standalone broker-dealers. As a corollary, the proposed rule could give dual-registrants a competitive advantage over standalone broker-dealers.

Beyond having an effect on competition among broker-dealers, it is possible that the proposed rule could affect competition between broker-dealers and investment advisers. Whether the proposed rule will have an effect on competition between broker-dealers and investment advisers will depend on how they market their services for advice and how potential customers choose between the two. For certain retail customers, fee structure or costs may be the primary driver of the choice of whether to obtain advice from a broker-dealer or an investment adviser. For example, a buy-and-hold retail customer or a retail customer who does not trade often may find the one-time commission charge commonly charged by a broker-dealer preferable to the ongoing percent-of-assets under management fee of an investment adviser. Because the proposed rules are not likely to change the way broker-dealers and investment advisers charge for their services, the proposed rules may not substantially alter the way in which retail customers that are sensitive to differences in fee structures and costs choose between the two.<sup>508</sup>

<sup>507</sup> See Fiduciary Duty Interpretive Release.

<sup>508</sup> A customer's relationship with an associated person of a broker-dealer or investment adviser may also influence the proposed rule's effect on how customers choose between the two. For example, customers who have relationships with an associated person outside of their professional relationship (e.g., they are members of the same family, they are friends, they are members of the same or similar organizations) may choose the associated person, at least in part, based on those outside relationships. To the extent customers and

<sup>506</sup> "Gains from trade" is defined as the difference between the highest price a consumer is willing to pay for a product or service and the lowest price at which the producer is willing to supply the product or service. See Section IV.B.b.

It may be the case, however, that certain retail customers base their choice between a broker-dealer and an investment adviser, at least in part, on their perception of the standards of conduct each owes to their customers. For example, there may be retail customers who prefer the commission structure of a broker-dealer, but who also prefer the fiduciary standard of conduct applicable to investment advisers. For certain of those retail customers, the preference for a fiduciary standard of care may lead them to choose an investment adviser. Because the proposed rule establishes a best interest standard of conduct that incorporates and goes beyond the current broker-dealer standard of conduct, broker-dealers may be better able to compete with investment advisers for those customers. To the extent that there are customers who prefer the commission structure of a broker-dealer, but who chose to use an investment adviser because of their fiduciary standard of conduct, we expect that the proposed rule will enhance competition between broker-dealers and investment advisers.

The gains from trade that result from broker-dealers complying with Regulation Best Interest may depend also on the type of products being recommended. It may be the case that for certain products that broker-dealers are currently offering, the best interest standard improves the gains from trade to such an extent that retail customer demand for broker-dealers' recommendations with respect to those products increases. Similarly, the best interest standard may also have a positive impact on retail customer demand for broker-dealer recommendations in the case of products that are currently offered only by a limited set of broker-dealers. The overall potential increase in the demand for broker-dealer recommendations would encourage entry in the broker-dealer sector, which would tend to lead to increased competition among broker-dealers. An increase in competition could manifest itself in terms of better service, better pricing, or some combination of the two, for retail customers.

Conversely, it may be the case that for some products the best interest standard reduces the gains from trade to such an extent that broker-dealers determine to

no longer make recommendations to retail customers with respect to those products. The potential decline in the number of broker-dealers willing to provide recommendations to their brokerage customers for these products may have negative competitive effects within the markets where these products are traded. For instance, if a significant portion of the trading volume in these products flows from retail customers acting on recommendations from broker-dealers, then the possibility of broker-dealers no longer offering recommendations on these products may adversely impact the pricing and availability of these products.

The potentially negative impact of complying with the best interest obligation of the proposed rule on the pricing of products that may no longer be part of some broker-dealers' product offering would likely be diminished for those products that are available to purchase outside a broker-dealer distribution channel. Products that broker-dealers offer advice on currently also may be offered through other non-broker-dealer channels such as investment advisers and commercial banks. For example, commercial banks can engage in broker-dealer activity, subject to certain conditions, without having to register as broker-dealers.<sup>509</sup> The decline in the supply of these products through broker-dealer recommendations may cause product sponsors to increase the supply of these products through non-broker-dealer entities that offer advice. In turn, this potential increase in supply may offset some of the potential negative effects of the proposed rule on the pricing of these products.

In addition, the possibility that broker-dealers may determine to no longer offer recommendations related to certain products that are subject to compensation arrangements with product sponsors may have a potential competitive impact on product sponsors. To the extent that product sponsors compete over funding for their products based on compensation arrangements with broker-dealers, the mitigation measures that broker-dealers may implement to comply with the best interest obligation, such as the potential elimination of some of these products, may change how product sponsors compete with each other. For instance, product sponsors may, under the proposed rules, choose to compete based on product quality rather than

compensation arrangements with the broker-dealers that distribute the products.

*Capital Formation and Efficiency.* As noted above, to the extent that the proposed rule improves the gains from trade for retail customers, these enhanced gains from trade could, in turn, result in current retail customers being willing to invest more of their savings in securities markets and potential retail customers being willing to invest through broker-dealers for the first time. To the extent that the proposed rule leads to greater investment, it may promote capital formation by supplying more capital to issuers at lower cost.

A portion of the enhanced gains from trade may be attributable to the best interest standard enhancing the quality of recommendations provided by broker-dealers to retail customers relative to the baseline. Recommendations that broker-dealers make to retail customers would be of higher quality if they were to promote investment opportunities that better help customers achieve their investment goals. These recommendations are not only consistent with the proposed best interest standard but may also reflect the higher effort that broker-dealers expend to understand the universe of investment opportunities that would fit best with the retail customers' investment profiles. Higher quality recommendations may also be a manifestation of the proposed rules' impact on competition between broker-dealers that may choose to compete more intensively on the quality of recommendations. At the same time, however, the incentives of broker-dealers to expend effort when providing quality recommendations would depend on how broker-dealers choose to respond to this rule and, if they continue to make recommendations to brokerage customers, how they choose to mitigate certain material conflicts of interest. To the extent that the tradeoff between enhancing the quality of advice and mitigating material conflicts of interest results in facilitating higher quality broker-dealer recommendations to retail customers, Regulation Best Interest could improve the efficiency of retail customers' portfolios that benefit from broker-dealer advice.

Among investment opportunities that better help customers achieve their savings goals, there would be some that would finance valuable projects in the corporate sector of the economy (as opposed to the financial sector, e.g., expanding the production of a product that is in high demand). To the extent that a retail customer acting on a high-

associated persons have relationships outside of their professional relationships and to the extent those outside relationships are determinative of the customer's choice between a broker-dealer and an investment adviser, the proposed rule would not substantially alter the way customers choose between the two.

<sup>509</sup> See Exchange Act Sections 3(a)(4)(B) and 3(a)(5)(B) and rules thereunder (providing banks exceptions from "broker" and "dealer" status for specified securities activities).

quality broker-dealer recommendation efficiently allocates new capital to an investment opportunity that funds valuable corporate sector projects, Regulation Best Interest, as proposed, could improve the efficiency with which capital in the economy is allocated to the corporate sector.

As noted above, the proposed rule also may have potentially differential implications for recommendations related to different products, leading to heterogeneous impacts on capital formation. In markets for financial products where the best interest standard improves the gains from trade, or where the benefits from ameliorating conflicts exceed the costs of additional requirements, the proposed rule could result in increased retail customer demand for broker-dealer recommendations for these products from current retail customers, as well as new retail customers. To the extent that increased demand for broker-dealer recommendations for particular products leads retail customers to allocate more capital to securities markets, and given the role of broker-dealers in the capital formation process, we could expect greater demand for such products which could, in turn, promote capital formation. In contrast, for those products where the best interest standard could erode the gains from trade, the supply of broker-dealer recommendations may decline, producing the opposite effect on capital formation. At the same time, the potential decline in the supply of broker-dealer recommendations on these products may negatively impact the efficiency of portfolio allocation of those retail customers who might otherwise benefit from broker-dealer recommendations with respect to these products. In addition, a reduction in broker-dealers' propensity to recommend certain products could impair the efficiency with which capital in the economy is allocated to the corporate sector.

As discussed earlier, the mitigation measures that broker-dealers may implement to comply with the best interest obligation with respect to conflicts of interest arising from compensation arrangements with product sponsors may result in product sponsors competing over funding based on features other than compensation arrangements, such as product quality. In turn, competition among product sponsors based on product quality may result in more funding going to the higher quality products, and hence may increase capital allocation efficiency.

### *E. Reasonable Alternatives*

The proposed rule would require broker-dealers, when recommending any securities transaction or investment strategy involving securities to a retail customer, to act in the best interest of the retail customer at the time of the recommendation and would require that broker-dealers act without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of the broker or dealer making the recommendation, ahead of the retail customer's interest. In this section, a number of alternatives to proposed Regulation Best Interest are discussed, including: (1) A disclosure-only alternative; (2) a principles-based standard of conduct obligation; (3) a fiduciary standard for broker-dealers; and (4) enhanced standards akin to conditions of the BIC Exemption.<sup>510</sup>

#### 1. Disclosure-Only Alternative

As an alternative to proposed Regulation Best Interest, that includes Disclosure, Care, and Conflict of Interest Obligations, the Commission could have the Disclosure Obligation alone, whereby broker-dealers would be obligated to disclose all material facts and conflicts, rather than also requiring broker-dealers to establish, maintain, and enforce policies and procedures to disclose (and mitigate) or eliminate material conflicts of interest associated with recommendations or financial incentives associated with recommendations. Under a disclosure-only alternative, broker-dealers would need to provide disclosure of material facts relating to the scope and term of the relationship, disclosure of material conflicts of interest with respect to the recommendation itself, and disclosures pertaining to broker-dealer compensation arrangements with third parties and their internal compensation structure. Relative to the current baseline of disclosure required by broker-dealers, a disclosure-only alternative would increase the amount of disclosure provided to retail customers and would bring such disclosure under the Exchange Act. Further, such enhanced disclosure could provide benefits to retail customers through increased information about material facts about the broker-dealer and customer relationship as well as potential conflicts of interest that broker-dealers may have.

Under the disclosure-only alternative, the proposed Relationship Summary and Regulatory Status Disclosure could

serve as key components of any additional disclosure that would be required under the disclosure-only alternative. In our concurrent rulemaking, we propose to:<sup>511</sup> (1) Require broker-dealers and investment advisers to deliver to retail investors a short (*i.e.*, four page or equivalent limit if in electronic format) relationship summary<sup>512</sup> and (2) require broker-dealers and investment advisers, and their associated natural persons and supervised persons, respectively, to disclose in retail investor communications the firm's registration status with the Commission and an associated natural person's and supervised person's relationship with the firm ("Regulatory Status Disclosure").<sup>513</sup>

Under this alternative, the overall costs to broker-dealers to comply with the requirements of the rule would be larger than those associated with currently required disclosure for broker-dealers; however, the costs to comply would likely be lower relative to proposed Regulation Best Interest.

The Commission preliminarily believes that a rule that only required the disclosure of conflicts of interest would be less effective than the proposed rule because broker-dealers would not be required to act in the best interest of their customers under the Exchange Act.<sup>514</sup> An alternative that only provides disclosure of conflicts of interest could therefore be less effective in increasing retail customer protection in the absence of the best interest requirement, relative to the proposed rule. Further, a disclosure-only alternative puts the burden on the retail customer to understand the disclosure and evaluate the magnitude of the conflict, without the benefit of a best interest standard of conduct of proposed Regulation Best Interest.<sup>515</sup> Therefore, the Commission preliminarily believes that a disclosure-only rule would be less effective in providing retail customer

<sup>511</sup> See Relationship Summary Proposal.

<sup>512</sup> The customer or client relationship summary is being proposed as "Form CRS."

<sup>513</sup> See Relationship Summary Proposal.

<sup>514</sup> The disclosure-only alternative would not provide the Care Obligation required by proposed Regulation Best Interest, as discussed above. However, FINRA Rule 2111 would continue to set a minimum requirement regarding the advice that broker-dealers provide to their customers, and therefore, would continue to address the competency of the advice provided by the broker-dealers.

<sup>515</sup> Relative to the disclosure-only alternative, broker-dealers under proposed Regulation Best Interest would have to act in the best interest of their investors, comply with the Care Obligation, and would have to take actions to eliminate or disclose, and where applicable, mitigate and disclose conflicts of interest.

<sup>510</sup> See BIC Exemption.



protection and reducing potential investor harm than proposed Regulation Best Interest.

## 2. Principles-Based Standard of Conduct Obligation

As an alternative, the Commission could rely on a principles-based standard of conduct, which could be developed by each broker-dealer based on its business model rather than directly requiring conduct standards. Under this alternative, broker-dealers would be required to comply with a principles-based approach to providing recommendations that are in the best interest of their customers, without expressly being subject to requirements to disclose, mitigate, or eliminate conflicts of interest. This alternative would focus on the competence of broker-dealers to provide advice and would continue to rely on SRO rules and the antifraud provisions of the federal securities laws and SRO rules to address broker-dealer conflicts. A principles-based standard of conduct would provide increased flexibility for broker-dealers to tailor their recommendations to retail customers, subject to the current obligations under the existing regulatory baseline, discussed above, to make suitable recommendations. This approach could impose lower compliance costs on regulated entities relative to the requirements of the proposed rule.

The Commission preliminarily believes that an approach that does not include the express requirements of the Disclosure, Care, or the requirements of the Conflict of Interest Obligations is likely to be less effective at reducing harm to retail customers that arises from conflicts of interest. Further, because each broker-dealer could have its own principles-based approach to meeting its care obligation under the Exchange Act, broker-dealers could interpret the standard differently. Variations in retail customer protection could make it difficult for retail customers to evaluate the standard of care offered by a broker-dealer and compare these across broker-dealers.

By contrast, Regulation Best Interest is designed to set a standard applicable to all broker-dealers. In the absence of a requirement to disclose or eliminate conflicts of interest or a requirement to mitigate financial conflicts,<sup>516</sup> as in proposed Regulation Best Interest, some firms may not undertake such mitigation techniques, either as they

<sup>516</sup> As discussed above, under a principles-based care obligation, broker-dealers would be required to continue to comply with the existing regulatory baseline, including disclosure obligations under the antifraud provisions of the federal securities laws.

pertain to material conflicts of interest or those related to financial incentives. Therefore, the Commission preliminarily believes that a principles-based standard of conduct approach on its own, would be less effective from a retail customer protection standpoint than the proposed Regulation Best Interest. A principles-based standard of conduct that obligates broker-dealers to act in the best interest of their retail customers, without guidance on what a best interest standard entails, is only one element that is needed to reduce potential investor harm and that investor protection is likely to be enhanced with the Disclosure, Care, and Conflict of Interest Obligations in proposed Regulation Best Interest.

## 3. A Fiduciary Standard for Broker-Dealers

As an alternative, the Commission could impose a fiduciary standard on broker-dealers for retail customers.<sup>517</sup> Fiduciary standards vary among investment advisers, banks, acting as trustees or fiduciaries, or ERISA plan providers, but fiduciaries are generally required to act with a duty of care and duty of loyalty to their clients.

As discussed above, any prescribed standard of conduct, such as a fiduciary standard, can seek to address the principal-agent problem between retail customers and firms and financial professionals, whereby principals (retail customers) are concerned that their agents (firms and financial professionals) will not act in the best interest of the principal. In the context of investment advice, firms and financial professionals may have incentives (financial or otherwise) to provide advice to their retail customers that benefits the firm or the financial professional but may be suboptimal from the retail customer's perspective. For example, a financial professional might offer costly products, when low(er) cost alternatives are reasonably available, may offer affiliated or proprietary products, or may trade more or less frequently than is beneficial to the retail customer. As discussed above in the discussion of broad economic considerations, retail customers may not be able to adequately monitor the firms or financial professionals to ensure that their agents are working in the retail customer's best interest. Therefore, regardless of the type of investment professional providing the advice, that advice may be conflicted and potentially harm retail customers.

<sup>517</sup> Retail customers would consist of the same set of investors as in proposed Regulation Best Interest.

Although conflicts of interest may exist in any type of relationship, the nature of such conflicts vary depending on the type of firm or financial professional that provides the advice. Broker-dealers and registered representatives generally provide financial advice at the transactional level, and the nature of the relationship between customers and broker-dealers and the level of monitoring by broker-dealers tends to be episodic, rather than ongoing. Investment advisers and their representatives commonly provide ongoing monitoring to their clients. Because of the differences in the nature of the relationship, the conflicts that are likely to arise from broker-dealers (e.g., offering mutual funds with large front-end loads or churning retail customer accounts) would be different from those that arise for many standalone investment advisers (e.g., so-called "reverse churning") but may be the same as the conflicts faced by advisers when the advisers, affiliates, or third-party broker-dealers with which advisory personnel are associated receive compensation in a broker-dealer capacity.<sup>518</sup>

Over time, different bodies of laws and standards have emerged that are generally tailored to the different business models of broker-dealers and investment advisers and that provide retail customer protection specific to the relationship types and business models to which they apply. While obligations for broker-dealers and investment advisers that arose from common law may appear similar, each set of laws and obligations has emerged independently. Moreover, such differences between business models have provided retail customers with choice about the type of investment advice that they seek and how they pay for such advice.

A fiduciary standard for broker-dealers could produce greater uniformity between broker-dealers' and investment advisers' standards. A uniform fiduciary standard for broker-dealers and investment advisers could bring more uniformity to the professional standards of conduct regarding advice provided to retail customers. A uniform standard could potentially reduce certain conflicts and increase disclosure of others, thereby enhancing the quality of such advice,

<sup>518</sup> As discussed above, nearly 80% of investment adviser representatives are also registered representatives of broker-dealers; thus, those representatives and their firms, depending on the capacity in which the representatives provide advice, could face similar conflicts. Further, nearly 75% of total investment adviser assets under management are associated with investment advisers that have a broker-dealer affiliate. See Section IV.C.1.

lowering the possibility of harm to investors, and potentially reducing retail customer confusion with respect to investment advice. The Commission preliminarily believes such uniformity would likely affect the market for investment advice provided by broker-dealers; retail customer choice; costs of investment advice; and could lead to the potential loss of differentiation between two important business models, each of which can serve a valuable function for retail customers. This alternative also could have economic effects on both retail customers and the industry, particularly if payment choice, account choice, or product choice diminishes as a result. Regardless of the form of a new fiduciary standard for broker-dealers, legal certainty would be an important factor for broker-dealers and other providers of investment advice.

As discussed above, the broker-dealer and investment adviser models have emerged to meet the investing and advice needs of particular clienteles with varying needs for monitoring, advice, and services. Given the different business models, different standards have emerged to provide retail customer protection reflective of the business model. We preliminarily believe that a uniform fiduciary standard that would attempt to fit a single approach to retail customer protection to two different business models is unlikely to provide a tailored solution to the conflicts that uniquely arise for either broker-dealers or investment advisers.<sup>519</sup> Moreover, such an alternative would likely undermine efforts to preserve the ability of broker-dealers to employ business models that are distinct from investment advisers', and could thereby limit retail customer choice with respect to investment advice. This differentiated approach to customer protection is more likely to provide more appropriate investor protection commensurate with the risks inherent in each of those business models. The nature of retail investors' relationships with providers of financial advice is likely to differ between broker-dealers and investment advisers (*e.g.*, broker-dealers are more likely to provide advice on an episodic basis), which has led to the emergence of different regulatory regimes, each designed to address conflicts of interest that may arise as a result of a given business model. Therefore, the Commission preliminarily believes that it is appropriate to maintain separate regulatory standards for broker-dealers and investment advisers, while

<sup>519</sup> An example of a uniform fiduciary standard is the staff recommendation in the 913 Study. *See supra* note 38 and accompanying text.

proposing to incorporate and go beyond existing levels of retail customer protection for broker-dealer customers through Regulation Best Interest and Form CRS Relationship Summary Disclosure.

#### 4. Enhanced Standards Akin to Conditions of the BIC Exemption

The Commission could alternatively propose a fiduciary standard coupled with a series of disclosure and other requirements akin to the full complement of conditions of the DOL's BIC Exemption adopted in connection with the DOL Fiduciary Rule, which would apply to broker-dealers when making investment recommendations for all types of retail accounts rather than only in connection with services to retirement accounts.<sup>520</sup> The key conditions of the BIC Exemption are described in some detail in Section I.A.2. Below, we consider the tradeoffs to retail customers, broker-dealers, and other market participants of an alternative that would mirror the key conditions of the BIC Exemption.<sup>521</sup>

The alternative of requiring broker-dealers to adopt a fiduciary standard coupled with a series of disclosure and other requirements akin to the full complement of conditions of the DOL's BIC Exemption for all retail customer accounts and not solely with respect to retirement assets could likely have economic effects for broker-dealers. Given that some broker-dealers have already adopted some of the conditions of the DOL's BIC Exemption for retirement accounts and may have already implemented the conditions for non-retirement accounts, the incremental costs could be low under such an alternative. However, the incremental costs could be reduced only to the extent that broker-dealers have already begun to implement the

<sup>520</sup> As discussed *supra* Section I.A.2., broker-dealers and their associated persons who provide fiduciary investment advice to retirement accounts (including ERISA-covered plans and participants, as well as IRAs) are not *required* to comply with the BIC Exemption to the extent that they are able to adopt an alternate approach to avoiding non-exempt prohibited transactions.

<sup>521</sup> The DOL also adopted the Impartial Conduct Standards in the Principal Transactions Exemption and certain other PTEs relating to the DOL Fiduciary Rule, see DOL Fiduciary Rule Release, *supra* note 49, 81 FR at 20991; these other PTEs operate with additional and/or different conditions from the BIC Exemption. This discussion only considers the conditions of the BIC Exemption, because it provides an example of the types of information and detail required under PTEs related to the DOL Fiduciary Rule, and we understand that most broker-dealers providing services to retirement accounts generally would rely on the BIC Exemption. As discussed above, the DOL Fiduciary Rule was vacated by the United States Court of Appeals for the Fifth Circuit on March 15, 2018. *See supra* note 51.

conditions of the DOL's BIC Exemption. Further, as discussed above, some components of the DOL's BIC Exemption are already part of the broker-dealer regulatory framework; therefore, any potential economic effects associated with such conditions would be reduced.

An alternative that would impose on broker-dealers a fiduciary standard coupled with set of requirements akin to the full complement of the BIC Exemption conditions could drive up costs to retail customers of obtaining investment advice from broker-dealers, and could cause some retail customers to forgo advisory services through broker-dealers if they were priced out of the market.<sup>522</sup> For example, if the costs associated with complying with a set of requirements akin to the full complement of conditions under BIC Exemption are large, broker-dealers could transition away from commission-based brokerage accounts to fee-based advisory accounts.<sup>523</sup> To the extent that such an outcome increases the costs associated with investment advice, some retail customers may determine to exit the market for financial advice.

Alternatively, as costs of complying with a fiduciary standard coupled with a set of requirements akin to the full complement of BIC Exemption conditions increase, some broker-dealers may abandon certain subsets of retail customer accounts, which would similarly deprive some broker-dealer customers of investment advice. A set of requirements that are akin to the conditions of the BIC Exemptions, were they to be imposed upon broker-dealers for all retail customer accounts, would also likely have competitive effects for both broker-dealers and investment advisers,<sup>524</sup> and could cause exit or consolidation among both broker-dealers and investment advisers that provide investment advice,<sup>525</sup> which could further reduce the overall level of investment advice available to retail

<sup>522</sup> *See* SIFMA Study. *See also* the ABA survey and the Financial Services Roundtable survey, *supra* note 456.

<sup>523</sup> As discussed in the baseline section, the average fees associated with broker-dealers' commission-based accounts are significantly lower than the average fees associated with fee-based accounts of registered investment advisers.

<sup>524</sup> Investment advisers, depending on how they are compensated, generally would not have to comply with the full set of obligations of the BIC Exemption, thereby reducing the costs to such firms, and providing incentives for broker-dealers to switch customers from transaction-based accounts to advisory accounts.

<sup>525</sup> In addition to competitive effects for broker-dealers and investment advisers, any change in the competitive environment is likely to have an impact on other providers of financial advice, including banks, and trust companies.

customers.<sup>526</sup> Further, for those broker-dealers that do not fully exit the market, implementing a set of requirements that are akin to the conditions of the BIC Exemption could lead to some broker-dealers transitioning from a broker-dealer business model to an investment adviser business model. Although this alternative could increase the competition between investment advisers and broker-dealers subject to a fiduciary standard and BIC Exemption-like conditions, any reduction in the costs of investment advice due to a potential increase in the supply of providers would likely be mitigated as the costs to broker-dealers to follow such standards would likely be large and could raise the costs associated with the provision of investment advice.<sup>527</sup>

The Commission preliminarily believes that requiring broker-dealers to comply with a fiduciary standard coupled with a set of requirements akin to the full complement of conditions under the BIC Exemption could impose costs on broker-dealers and impact retail customers and the market for investment advice; however, the Commission is unable to quantify the costs and benefits associated with this alternative. Moreover, the Department of Labor has a different regulatory focus than the Commission; therefore, a wholesale incorporation of conditions consistent with the BIC Exemption is not entirely consistent with the regulatory approach of the Commission.

#### F. Request for Comment

The Commission requests comment on all aspects of this initial economic analysis, including whether we have correctly identified the problem, its magnitude, and the set of reasonably available solutions and alternative approaches. We also request comment on whether the analysis has: (i) Identified all benefits and costs, including all effects on efficiency, competition, and capital formation; (ii) given due consideration to each benefit and cost, including each effect on efficiency, competition, and capital formation; and (iii) identified and considered reasonable alternatives to the proposed regulations. We request and encourage any interested person to submit comments regarding the proposed regulations, our analysis of the

potential effects of the proposed regulations, and other matters that may have an effect on the proposed regulations. We request that commenters identify sources of data and information as well as provide data and information to assist us in analyzing the economic consequences of the proposed regulations. We also are interested in comments on the qualitative benefits and costs we have identified and any benefits and costs we may not have discussed. We also request comment on the assumptions underlying our analysis and cost estimates.

In addition to our general request for comment on the economic analysis associated with the proposed regulations, we request specific comment on certain aspects of the proposal:

- We request comment on our characterization of the relationship between a broker-dealer and a retail customer. Do commenters agree with our principal-agent characterization of this relationship? Are there different ways of characterizing this relationship that we should consider? Is the concept of “gains from trade” appropriate for capturing the economic impact of the proposed regulation on the broker-dealers and their retail customers? Are there alternative economic concepts that we should consider? Is the example that illustrates how the concept of “gains for trade” works useful for understanding the economic impacts of the proposed regulation? Can commenters suggest alternative examples?

- We request comment on our assumptions related to identifying broker-dealers that are likely to have retail customers. If only “sales” activity is marked on Form BR, is it appropriate to assume that a firm has both “retail” and “institutional” sales activities?

- We request comment on the financial incentives provided by broker-dealers to registered representatives and other associated persons of the broker-dealer. Are the ranges provided reasonable? Are there other types of compensation arrangements or financial incentives that are provided to associated persons of broker-dealers, particularly registered representatives, which are not included in the baseline? Please be specific and provide data and analysis to support your views.

- We request comment on our characterization of the benefits of proposed Regulation Best Interest. We believe that the proposed rule achieves its main benefits by ameliorating the agency conflict between broker-dealers and retail customers. Do commenters agree with our characterization of the benefits? Are there other benefits of the

proposed rule that have not been identified in our discussion and that warrant consideration? Are the assumptions that form the basis of our analysis of the benefits appropriate? Can commenters provide data that supports or opposes these assumptions? Can commenters provide data that would help the Commission quantify the magnitude of the benefits identified in our discussion or other benefits that we missed to identify in our discussion and that warrant consideration?

- We request comment on our characterization of the costs of the proposed Regulation Best Interest. We believe that the best interest obligation through its component obligations would impose direct costs on broker-dealers. Furthermore, we believe that depending on how broker-dealers chose to comply with the best interest obligation, the proposed rule may impose costs on retail customers. Do commenters agree with our characterization of the costs? Are there other costs of the proposed rule that have not been identified in our discussion and that warrant consideration? Are the assumptions that form the basis of our analysis of the costs appropriate? Can commenters provide data that supports or opposes these assumptions? Can commenters provide data that would help the Commission quantify the magnitude of the costs identified in our discussion or other costs that we missed to identify in our discussion and that warrant consideration?

- How do commenters anticipate that the benefits and costs of the proposed rule will be shared between broker-dealers and their retail customers? Please be specific and provide data and analysis to support your views.

- Are there any effects on efficiency, competition, and capital formation that are not identified or are misidentified in our economic analysis? Please be specific and provide data and analysis to support your views.

- What would the costs for broker-dealers be if the provision of discretionary investment advice, whether or not limited in scope, were not to be considered “solely incidental” to broker-dealer’s business under Advisers Act rule 202(a)(11)(C)? Would there be any costs or benefits to retail customers? How would the market for the provision of financial advice change? Would dually-registered firms treat discretionary accounts as brokerage accounts?

- Do commenters believe that the alternatives the Commission considered are appropriate? Are there other reasonable alternatives that the

<sup>526</sup> As discussed above in Section IV.D, proposed Regulation Best Interest also could have competitive effects between broker-dealers and investment advisers.

<sup>527</sup> One of the main critiques of the BIC Exemption arises from the increased legal uncertainty and associated increased litigation risk for broker-dealers, as discussed above.

Commission should consider? If so, please provide additional alternatives and how their costs and benefits would compare to the proposal.

## V. Paperwork Reduction Act Analysis

Certain provisions of the proposed rules and rule amendments would impose new “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>528</sup>

The Commission is submitting the proposed rules and rule amendments to the Office of Management and Budget (“OMB”) for review and approval in accordance with the PRA.<sup>529</sup> The titles for these collections of information are: (1) “Regulation Best Interest;” (2) Rule 17a–3—Records to be Made by Certain Exchange Members, Brokers and Dealers (OMB control number 3235–0033);<sup>530</sup> and (3) Rule 17a–4—Records to be Preserved by Certain Brokers and Dealers (OMB control number 3235–0279).<sup>531</sup> OMB has not yet assigned a control number to the collection of information for “Regulation Best Interest.” An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Proposed pursuant to the Commission’s authority under the Dodd-Frank Act and the Exchange Act, Regulation Best Interest would: (1) Improve disclosure about the scope and terms of the broker-dealer’s relationship with the retail customer, which would foster retail customers’ understanding of their relationship with a broker-dealer; (2) enhance the quality of recommendations provided by establishing an express best interest obligation under the federal securities laws; (3) enhance the disclosure of a broker-dealer’s material conflicts of interest; (4) and establish obligations that require mitigation, and not just disclosure, of conflicts of interest arising from financial incentives associated with broker-dealer recommendations. Generally, in crafting proposed Regulation Best Interest, we aimed to provide broker-dealers flexibility in determining how to satisfy the component obligations. For purposes of this analysis, we have made assumptions regarding how a broker-dealer would comply with the

obligations of Regulation Best Interest, as well as the proposed amendments to Rule 17a–3(a)(25) and Rule 17a–4(e)(5).

### A. Respondents Subject to Proposed Regulation Best Interest and Proposed Amendments to Rule 17a–3(a)(25), Rule 17a–4(e)(5)

#### 1. Broker-Dealers

Proposed Regulation Best Interest would impose a best interest obligation on a broker-dealer when making recommendations of any securities transaction or investment strategy involving securities to “retail customers.” Except where noted, we have assumed that a dually-registered firm, already subject to the Investment Advisers Act, would be subject to new, distinct burdens under proposed Regulation Best Interest.

As of December 31, 2017, 3,841 broker-dealers were registered with the Commission—either as standalone broker-dealers or as dually-registered entities. Based on data obtained from Form BR, the Commission preliminarily believes that approximately 74.4% of this population, or 2,857 broker-dealers have retail customers and therefore would likely be subject to Regulation Best Interest and the proposed amendments to Rules 17a–3(a)(25) and 17a–4(e)(5).<sup>532</sup>

#### 2. Natural Persons who are Associated Persons of Broker-Dealers

As with broker-dealers, proposed Regulation Best Interest would impose a best interest obligation on natural persons who are associated persons of broker-dealers, when making recommendations of any securities transaction or investment strategy involving securities to “retail customers.”

The Commission preliminarily believes that approximately 435,071 natural persons would qualify as retail-facing, licensed representatives at standalone broker-dealers or dually-registered firms,<sup>533</sup> and would therefore likely be subject to proposed Regulation Best Interest, and the proposed

amendments to Rules 17a–3(a)(25) and 17a–4(e)(5).<sup>534</sup>

### B. Summary of Collections of Information

Regulation Best Interest would require broker-dealers to act in the best interest of a retail customer when recommending any securities transaction or investment strategy involving securities to a retail customer. As discussed above, proposed Regulation Best Interest would specifically provide that this best interest obligation shall be satisfied if: (1) The broker, dealer or natural person who is an associated person of a broker or dealer, prior to or at the time of a recommendation, reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer, including all material conflicts of interest that are associated with the recommendation; (2) the broker, dealer or natural person who is an associated person of a broker or dealer, exercises reasonable diligence, care, skill, and prudence in making a recommendation; (3) the broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations; and (4) the broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

Furthermore, the proposed addition of paragraph (a)(25) to Rule 17a–3 would impose new record-making obligations on broker-dealers subject to Regulation Best Interest, while the Proposed Amendment to Rule 17a–4(e)(5) would impose new record retention obligations on broker-dealers subject to Regulation Best Interest.

The obligations arising under Regulation Best Interest, the Proposed Amendment to Rule 17a–3(a)(25), and the Proposed Amendment to Rule 17a–4(e)(5) would give rise to distinct collections of information and

<sup>534</sup> Unless otherwise noted, for purposes of the PRA, we use the term “registered representatives” to refer to associated persons of broker-dealers who are registered, have series 6 or 7 licenses, and are retail-facing, and we use the term “dually-registered representatives of broker-dealers” to refer to registered representatives who are dually-registered and are associated persons of a standalone broker-dealer (who may be associated with an unaffiliated investment adviser) or a dually-registered broker-dealer.

<sup>528</sup> 44 U.S.C. 3501 *et seq.*

<sup>529</sup> 44 U.S.C. 3507(d) and 5 CFR 1320.11.

<sup>530</sup> See 17 CFR 240.17a–3. The proposed addition of paragraph (a)(25) to Rule 17a–3 would amend the existing PRA for Rule 17a–3.

<sup>531</sup> See 17 CFR 240.17a–4. The Proposed Amendment to Rule 17a–4(e)(5) would amend the existing PRA for Rule 17a–4.

<sup>532</sup> As of December 31, 2017, 3,841 broker-dealers filed Form BD. Retail sales by broker-dealers were obtained from Form BR.

<sup>533</sup> See Section IV.B.1, *supra*, at Table 5. This estimate is based on the following calculation: (494,399 total licensed representatives (including representatives of investment advisers)) × (12% (the percentage of total licensed representatives who are standalone investment adviser representatives)) = 59,328 representatives at standalone investment advisers. To isolate the number of representatives at standalone broker-dealers and dually-registered firms, we have subtracted 59,328 from 494,399, for a total of 435,071 retail-facing, licensed representatives at standalone broker-dealers or dually-registered firms.

associated costs and burdens for broker-dealers subject to the proposed rules.

The collections of information associated with these proposed rules and proposed rule amendments are described below.

### 1. Conflict of Interest Obligations

Regulation Best Interest would require a broker-dealer entity<sup>535</sup> to establish, maintain, and enforce written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with a recommendation. Second, Regulation Best Interest would require a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with a recommendation.

Written policies and procedures developed pursuant to the Conflict of Interest Obligations of proposed Regulation Best Interest would help a broker-dealer develop a process, relevant to its retail customers and the nature of its business, for identifying material conflicts of interest, and then determining whether to eliminate, or disclose and/or mitigate, the material conflict and the appropriate means of eliminating, disclosing, and/or mitigating the conflict. As a result of a broker-dealer's eliminating, disclosing, and/or mitigating the effects of conflicts of interest on broker-dealer recommendations, retail customers would more likely receive recommendations in their best interest. In addition, the retention of written policies and procedures would generally: (1) Assist a broker-dealer in supervising and assessing internal compliance with Regulation Best Interest; and (2) assist the Commission and SRO staff in connection with examinations and investigations.<sup>536</sup>

<sup>535</sup> As discussed above in Section II.D.3, the proposed Conflict of Interest Obligation applies solely to the broker or dealer entity, and not to the natural persons who are associated persons of a broker or dealer. For purposes of discussing the Conflict of Interest Obligation, the term "broker-dealer" refers only to the broker-dealer entity, and not to such individuals.

<sup>536</sup> Any written policies and procedures developed pursuant to proposed Regulation Best Interest would be required to be retained pursuant to Exchange Act Rule 17a-4(e)(7), which requires broker-dealers to retain compliance, supervisory, and procedures manuals (and any updates, modifications, and revisions thereto) describing the policies and practices of the broker-dealer with respect to compliance with applicable laws and rules, and supervision of the activities of each natural person associated with the broker-dealer, for a specified period of time. The record retention requirements of Rule 17a-4(e)(7) include any

Following is a detailed discussion of the estimated costs and burdens associated with broker-dealers' Conflict of Interest Obligations.

#### a. Written Policies and Procedures

##### (1) Initial Costs and Burdens

We believe that most broker-dealers have policies and procedures in place to address material conflicts, but they do not necessarily have written policies and procedures regarding the identification and management of conflicts as proposed in Regulation Best Interest. To initially comply with this obligation, we believe that broker-dealers would employ a combination of in-house and outside legal and compliance counsel to update existing policies and procedures.<sup>537</sup> We assume that, for purposes of this analysis, the associated costs and burdens would differ between small and large broker-dealers, as large broker-dealers generally offer more products and services and therefore would need to evaluate and address a greater number of potential conflicts. Based on FOCUS Report data,<sup>538</sup> we estimate that, as of December 31, 2017, approximately 802 broker-dealers are small entities under the RFA. Therefore, we estimate that 2,055 broker-dealers would qualify as large broker-dealers for purposes of this analysis.<sup>539</sup>

As an initial matter, we estimate that a large broker-dealer would incur a one-time average internal burden of 50 hours for in-house legal and in-house compliance counsel to update existing policies and procedures to comply with Regulation Best Interest.<sup>540</sup> We additionally estimate a one-time burden of 5 hours for a general counsel at a large broker-dealer and 5 hours for a Chief Compliance Officer to review and approve the updated policies and procedures, for a total of 60 burden

written policies and procedures that broker-dealers may produce pursuant to Regulation Best Interest's Conflict of Interest Obligations. The costs and burdens associated with Rule 17a-4(e)(7) will be updated in connection with the next renewal for the PRA.

<sup>537</sup> Throughout this PRA analysis, the burdens on in-house personnel are measured in terms of burden hours, and external costs are expressed in dollar terms.

<sup>538</sup> FOCUS Reports, or "Financial and Operational Combined Uniform Single" Reports, are monthly, quarterly, and annual reports that broker-dealers are generally required to file with the Commission and/or SROs pursuant to Exchange Act Rule 17a-5. See 17 CFR 240.17a-5.

<sup>539</sup> This calculation was made as follows: (2,857 total retail broker-dealers) - (802 small broker-dealers) = 2,055 large broker-dealers.

<sup>540</sup> This estimate would be broken down as follows: 40 hours for in-house legal counsel + 10 hours for in-house compliance counsel to update existing policies and procedures = 50 burden hours.

hours.<sup>541</sup> In addition, we estimate a cost of \$4,720 for outside counsel to review the updated policies and procedures on behalf of a large broker-dealer.<sup>542</sup> We therefore estimate the aggregate burden for large broker-dealers to be 123,300 burden hours,<sup>543</sup> and the aggregate cost for large broker-dealers to be \$9.70 million.<sup>544</sup>

In contrast, we believe small broker-dealers would primarily rely on outside counsel to update existing policies and procedures, as small broker-dealers generally have fewer in-house legal and compliance personnel. Moreover, since small broker-dealers would typically have fewer conflicts of interest, we estimate that only 40 hours of outside legal counsel services would be required to update the policies and procedures, for a total one-time cost of \$18,880<sup>545</sup> per small broker-dealer, and an aggregate cost of \$15.1 million for all small broker-dealers.<sup>546</sup> We additionally believe in-house compliance personnel would require 10 hours to review and approve the updated policies and procedures, for an aggregate burden of 8,020 hours.<sup>547</sup>

We therefore estimate the total initial aggregate burden to be 131,320 hours,<sup>548</sup> and the total initial aggregate cost to be \$24.8 million.<sup>549</sup>

<sup>541</sup> This estimate is based on the following calculation: (50 hours of review for in-house legal and in-house compliance counsel) + (5 hours of review for general counsel) + (5 hours of review for Chief Compliance Officer) = 60 burden hours.

<sup>542</sup> Based on industry sources, Commission staff preliminarily estimates that the average hourly rate for legal services is \$472/hour. This cost estimate is therefore based on the following calculation: (10 hours of review) × (\$472/hour for outside counsel services) = \$4,720 in outside counsel costs.

<sup>543</sup> This estimate is based on the following calculation: (60 burden hours of review per large broker-dealer) × (2,055 large broker-dealers) = 123,300 aggregate burden hours.

<sup>544</sup> This estimate is based on the following calculation: (\$4,720 for outside counsel costs per large broker-dealer) × (2,055 large broker-dealers) = \$9.70 million in outside counsel costs.

<sup>545</sup> This cost estimate is based on the following calculation: (40 hours of review) × (\$472/hour for outside counsel services) = \$18,880 in outside counsel costs.

<sup>546</sup> This cost estimate is based on the following calculation: (\$18,880 for outside attorney costs per small broker-dealer) × (802 small broker-dealers) = \$15.1 million in outside counsel costs.

<sup>547</sup> This estimate is based on the following calculation: (10 burden hours) × (802 small broker-dealers) = 8,020 aggregate burden hours.

<sup>548</sup> This estimate is based on the following calculation: (123,300 aggregate burden hours for large broker-dealers) + (8,020 aggregate burden hours for small broker-dealers) = 131,320 total aggregate burden hours.

<sup>549</sup> This estimate is based on the following calculation: (\$9.70 million in aggregate costs for large broker-dealers) + (\$15.1 million in aggregate costs for small broker-dealers) = \$24.80 million total aggregate costs.

## (2) Ongoing Costs and Burdens

For purposes of this analysis, we have assumed that small and large broker-dealers would review and update policies and procedures on a periodic basis to accommodate the addition of, among other things, new products or services, new business lines, and/or new personnel. We also assume that broker-dealers would review and update their policies and procedures for compliance with Regulation Best Interest on an annual basis, and that they would perform the review and update using in-house personnel.

For large broker-dealers with more numerous, more complex products and services, and higher rates of hiring and turnover, we estimate that each broker-dealer would annually incur an internal burden of 12 hours to review and update existing policies and procedures: Four hours for legal personnel, four hours for compliance personnel, and four hours for business-line personnel to identify new conflicts. We therefore estimate an ongoing, aggregate burden for large broker-dealers of approximately 24,660 hours.<sup>550</sup> Because we assume that large broker-dealers would rely on internal personnel to update policies and procedures on an ongoing basis, we do not believe large broker-dealers would incur ongoing costs.

We assume for purposes of this analysis that small broker-dealers, with fewer and less complex products, and lower rates of hiring, would mostly rely on outside legal counsel and outside compliance consultants for review and update of their policies and procedures, with final review and approval from an in-house compliance manager. We preliminarily estimate that outside counsel would require approximately five hours per year to update policies and procedures, for an annual cost of \$2,360 for each small broker-dealer.<sup>551</sup> The projected aggregate, annual ongoing cost for outside legal counsel to update policies and procedures for small broker-dealers would be \$1.89 million.<sup>552</sup> In addition, we expect that small broker-dealers would require five hours of outside compliance services per year to update their policies and

<sup>550</sup> This estimate is based on the following calculation: (12 burden hours per large broker-dealer) × (2,055 large broker-dealers) = 24,660 aggregate ongoing burden hours.

<sup>551</sup> This estimate is based on the following calculation: (5 hours per small broker-dealer) × (\$472/hour for outside counsel services) = \$2,360 in outside counsel costs.

<sup>552</sup> This estimate is based on the following calculation: (\$2,360 in outside counsel costs per small broker-dealer) × (802 small broker-dealers) = \$1.89 million in aggregate, ongoing outside legal costs.

procedures, for an ongoing cost of \$1,490 per year,<sup>553</sup> and an aggregate ongoing cost of \$1.19 million.<sup>554</sup> The total aggregate, ongoing cost for small broker-dealers is therefore projected at \$3.08 million per year.<sup>555</sup>

In addition to the costs described above, we additionally believe small broker-dealers would incur an internal burden of approximately 5 hours for an in-house compliance manager to review and approve the updated policies and procedures per year. The ongoing, aggregate burden for small broker-dealers would be 4,010 hours for in-house compliance manager review.<sup>556</sup>

We therefore estimate the total ongoing aggregate ongoing burden to be 28,670 hours,<sup>557</sup> and the total ongoing aggregate cost to be \$3.08 million per year.<sup>558</sup>

The Commission acknowledges that policies and procedures may vary greatly by broker-dealer, given the differences in size and the complexity of broker-dealer business models. Accordingly, we would expect that the need to update policies and procedures might also vary greatly.

## b. Identification of Material Conflicts of Interest

## (1) Initial Costs and Burdens

With respect to identifying and determining whether a material conflict of interest exists in connection with a recommendation, a broker-dealer would first need to establish mechanisms to proactively and systematically identify conflicts of interest in its business on an ongoing or periodic basis.<sup>559</sup> For

<sup>553</sup> Based on industry sources, Commission staff preliminarily estimates that the average hourly rate for compliance services in the securities industry is \$298/hour. This cost estimate is based on the following calculation: (5 hours of review) × (\$298/hour for outside compliance services) = \$1,490 in outside compliance service costs.

<sup>554</sup> This estimate is based on the following calculation: (\$1,490 in outside compliance costs per small broker-dealer) × (802 small broker-dealers) = \$1.19 million in aggregate, ongoing outside compliance costs.

<sup>555</sup> This estimate is based on the following calculation: (\$1.89 million for outside legal counsel costs) + (\$1.19 million for outside compliance costs) = \$3.08 million total aggregate ongoing costs.

<sup>556</sup> This estimate is based on the following calculation: (5 hours compliance manager review per small broker-dealer) × (802 small broker-dealers) = 4,010 aggregate ongoing burden hours.

<sup>557</sup> This estimate is based on the following calculation: (24,660 aggregate ongoing burden hours for large broker-dealers) + (4,010 aggregate ongoing burden hours for small broker-dealers) = 28,670 total aggregate ongoing burden hours.

<sup>558</sup> This estimate is based on the following calculation: (\$3.08 million per year in total aggregate ongoing costs for small broker-dealers) + (\$0 projected ongoing costs for large broker-dealers) = \$3.08 million per year in total aggregate ongoing costs.

<sup>559</sup> See *supra* Section II.D.3.c.

purposes of this analysis, we understand that most broker-dealers already have an existing technological infrastructure in place, and we assume that such infrastructure would need to be modified to effect compliance with Regulation Best Interest.

Acknowledging that costs and burdens may vary greatly according to the size of the broker-dealer, we expect that the modification of a broker-dealer's existing technology would initially require the retention of an outside programmer, and that the modification of existing technology would require, on average, an estimated 20 hours of the programmer's labor, for an estimated cost per broker-dealer of \$5,400.<sup>560</sup> We additionally project that coordination between the programmer and the broker-dealer's compliance manager would involve five burden hours. The aggregate costs and burdens for the modification of existing technology to identify conflicts of interest would therefore be \$15.43 million,<sup>561</sup> and 14,285 burden hours.<sup>562</sup>

We additionally believe that the determination whether the conflicts of interest, once identified, are material, would require approximately five hours per broker-dealer,<sup>563</sup> for an aggregate of 14,285 burden hours for all broker-dealers.<sup>564</sup> The total aggregate burden for the identification of material conflicts is 28,570 hours.<sup>565</sup>

## (2) Ongoing Costs and Burdens

To maintain compliance with Regulation Best Interest, we assume for purposes of this PRA analysis that a broker-dealer would seek to identify additional conflicts as its business evolves. The Commission recognizes that the types of services and product offerings vary greatly by broker-dealer.

<sup>560</sup> Based on industry sources, Commission staff preliminarily estimates that the average hourly rate for technology services in the securities industry is \$270. This cost estimate is based on the following calculation: (20 hours of review) × (\$270/hour for technology services) = \$5,400 in outside programmer costs.

<sup>561</sup> This cost estimate is based on the following calculation: (\$5,400 in outside programmer costs per broker-dealer) × (2,857 retail broker-dealers) = \$15.43 million in aggregate outside programmer costs.

<sup>562</sup> This burden estimate is based on the following calculation: (5 burden hours) × (2,857 broker-dealers) = 14,285 aggregate burden hours.

<sup>563</sup> This burden estimate consists of 2.5 hours for review by a senior business analyst, and 2.5 hours for review by in-house compliance manager.

<sup>564</sup> This burden estimate is based on the following calculation: (5 burden hours) × (2,857 broker-dealers) = 14,285 aggregate burden hours.

<sup>565</sup> This burden estimate is based on the following calculation: (14,285 burden hours for modification of technology) + (14,285 burden hours for evaluation of conflict materiality) = 28,570 total aggregate burden hours.

However, for purposes of this analysis, we assume that broker-dealers would, at a minimum, engage in a material conflicts identification process on an annual basis.<sup>566</sup> We estimate that a broker-dealer's business line and compliance personnel would jointly spend, on average, 10 hours<sup>567</sup> to perform an annual conflicts review using the modified technology infrastructure. Therefore the aggregate, ongoing burden for an annual conflicts review, based on an estimated 2,857 retail broker-dealers, would be approximately 28,570 burden hours.<sup>568</sup> Because we assume that broker-dealers would use in-house personnel to identify and evaluate new, potential conflicts, we do not believe they would incur additional ongoing costs.

### c. Training

Pursuant to the obligation to "maintain and enforce" written policies and procedures, we additionally expect broker-dealers to develop training programs that promote compliance with Regulation Best Interest among registered representatives. The initial and ongoing costs and burdens associated with such a training program are estimated below.

#### (1) Initial Costs and Burdens

We believe that broker-dealers would likely use a computerized training module to train registered representatives on the policies and procedures pertaining to Regulation Best Interest. We estimate that a broker-dealer would retain an outside systems analyst, an outside programmer, and an outside programmer analyst to create the training module, at 20 hours, 40 hours, and 20 hours, respectively. The total cost for a broker-dealer to develop the training module would be

<sup>566</sup> Analogously, FINRA rules set an annual supervisory review as a minimum threshold for broker-dealers. *See, e.g.*, FINRA Rules 3110 (requiring an annual review of the businesses in which the broker-dealer engages); 3120 (requiring an annual report detailing a broker-dealer's system of supervisory controls, including compliance efforts in the areas of antifraud and sales practices); and 3130 (requiring each broker-dealer's CEO or equivalent officer to certify annually to the reasonable design of the policies and procedures for compliance with relevant regulatory requirements).

<sup>567</sup> This burden estimate consists of 5 hours for review by a senior business analyst, and 5 hours for review by an in-house compliance counsel or compliance manager.

<sup>568</sup> This estimate is based on the following calculation: (10 hours of labor per retail broker-dealer) × (2,857 retail broker-dealers) = 28,570 aggregate burden hours.

approximately \$21,600,<sup>569</sup> for an aggregate initial cost of \$61.7 million.<sup>570</sup>

Additionally, we expect that the training module would require the approval of the Chief Compliance Officer, as well as in-house legal counsel, each of whom we expect would require approximately 2 hours to review and approve the training module. The aggregate burden for broker-dealers is therefore estimated at 11,428 burden hours.<sup>571</sup>

In addition, broker-dealers would incur an initial cost for registered representatives to undergo training through the training module. We estimate the training time at one hour per registered representative, for an aggregate burden of 435,071 burden hours, or an initial burden of 152.3 hours per broker-dealer.<sup>572</sup> The total aggregate burden to approve the training module and implement the training program would be 446,699 burden hours.<sup>573</sup>

#### (2) Ongoing Costs and Burdens

We believe that, as a matter of best practice, broker-dealers would likely require registered representatives to repeat the training module for Regulation Best Interest on an annual basis. The ongoing aggregate cost for the one-hour training would be 435,071 burden hours per year, or 152.3 burden hours per broker-dealer per year.<sup>574</sup>

### 2. Disclosure Obligation

The Disclosure Obligation under proposed Regulation Best Interest would

<sup>569</sup> This estimate is based on the following calculation: ((20 hours of labor for a systems analyst) × (\$270/hour)) + ((40 hours of labor for a programmer) × (\$270/hour)) + ((20 hours of labor for a programmer analyst) × (\$270/hour)) = \$21,600 in external technology service costs per broker-dealer. As noted above, the \$270 estimated average hourly rate for technology services is based on industry sources.

<sup>570</sup> This estimate is based on the following calculation: (2,857 broker-dealers) × (\$21,600 cost per broker-dealer) = \$61.7 million in aggregate costs for technology services.

<sup>571</sup> This estimate is based on the following calculation: (2,857 broker-dealers) × (4 burden hours per broker-dealer) = 11,428 burden hours.

<sup>572</sup> This estimate is based on the following calculation: (1 burden hour) × (435,071 registered representatives at standalone or dually-registered broker-dealers) = 435,071 aggregate burden hours. Conversely, (435,071 aggregate burden hours) / (2,857 retail broker-dealers) = 152.3 initial burden hours per broker-dealer.

<sup>573</sup> This estimate is based on the following calculation: (435,071 burden hours for training of registered representatives) + (11,428 burden hours to approve training program) = 446,699 total aggregate burden hours.

<sup>574</sup> This estimate is based on the following calculation: (1 burden hour) × (435,071 registered representatives at standalone or dually-registered broker-dealers) = 435,071 burden hours. Conversely, (435,071 aggregate burden hours) / (2,857 retail broker-dealers) = 152.3 initial burden hours per broker-dealer.

require a broker-dealer, prior to or at the time of recommending a securities transaction or strategy involving securities to a retail customer, to: (1) Reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer; and (2) reasonably disclose to the retail customer, in writing, all material conflicts of interest that are associated with the recommendation. The Commission believes that requiring broker-dealers to reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with a retail customer would facilitate a retail customer's understanding of the nature of his or her account, the broker-dealer's fees and charges, as well as the nature of services that the broker-dealer provides, as well as any limitations to those services. It would also reduce retail customers' confusion about the differences among certain financial service providers, such as broker-dealers, investment advisers, and dual-registrants. In addition, the obligation to disclose all material conflicts of interest associated with a recommendation would raise retail customers' awareness of the potential effects of conflicts of interest, and increase the likelihood that broker-dealers would make recommendations that are in the retail customer's best interest.

The collections of information associated with these Disclosure Obligations, as well as the associated record-making and recordkeeping obligations are addressed below.

#### a. Obligation To Reasonably Disclose to the Retail Customer, in Writing, the Material Facts Relating to the Scope and Terms of the Relationship With the Retail Customer

The Commission assumes for purposes of this analysis that broker-dealers would meet their obligation to reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer through a combination of delivery of the Relationship Summary, creating account disclosures to include standardized language related to capacity and scope, and types of services and the development of comprehensive fee schedules.

#### (1) Disclosure of Capacity

As discussed above, the Commission preliminarily believes that a standalone broker-dealer would be able to satisfy its obligation to disclose that it is acting in a broker-dealer capacity by providing

the retail customer with the Relationship Summary in the manner prescribed by the rules and guidance in the Relationship Summary Proposal.<sup>575</sup>

We assume, for purposes of this PRA analysis, that a dually-registered broker-dealer would satisfy its obligation to disclose it is acting in a broker-dealer capacity by creating an account disclosure with standardized language, and by providing it to the retail customer at the beginning of the relationship. The account disclosure would set forth when the broker-dealer would be acting in a broker-dealer capacity, and how the broker-dealer would notify the retail customer of any changes in its capacity. We understand that many broker-dealers already include such information in account disclosures.

#### (2) Disclosure of Fees, Charges, and Types/Scope of Services

While many broker-dealers do provide fee information to retail customers in a fee schedule, the Commission believes that to comply with proposed Regulation Best Interest broker-dealers would likely either amend this schedule or develop a new fee schedule to disclose the fees and charges applicable to retail customers' transactions, holdings, and accounts through the use or development of a comprehensive, standardized fee schedule. This fee schedule would be delivered to retail customers at the beginning of a relationship. If, at the time the recommendation is made, the disclosure made to the retail customer is not current or does not contain all material facts regarding the fees of the particular recommendation, the broker-dealer would need to deliver an amended fee schedule.

With respect to disclosure of the types and scope of services provided by the broker-dealer, we assume for purposes of this PRA analysis that broker-dealers would satisfy the Disclosure Obligation by including this information in the account disclosure provided to the retail customer at the beginning of the relationship, as described above. The broker-dealer would need to deliver an amended account disclosure to the retail customer in the case of any material changes made to the type and scope of services.

#### b. Obligation To Reasonably Disclose in Writing All Material Conflicts of Interest That Are Associated With the Recommendation

Proposed Regulation Best Interest would require a broker-dealer to

reasonably disclose in writing all material conflicts of interest that are associated with a recommendation.

As discussed above, we preliminarily assume that broker-dealers would satisfy the obligation to disclose material conflicts of interest through the use of a standardized, written disclosure document provided to all retail customers and supplemental disclosure provided to certain retail customers for specific products.

We assume for purposes of this analysis that delivery of written disclosure would occur at the beginning of a relationship, such as together with the account opening agreement. For existing retail customers, the disclosure would need to occur "prior to or at the time" of a recommendation. Subsequent disclosures may be delivered in the event of a material change or if the broker-dealer determines additional disclosure is needed for certain types of products.

The corresponding estimated total annual reporting costs and burdens are addressed below.<sup>576</sup>

#### c. Estimated Costs and Burdens

##### (1) Disclosure of Capacity, Type and Scope of Services

Standalone broker-dealers would satisfy the obligation to disclose capacity through the delivery to retail customers of the Relationship Summary, in accordance with the rules and guidance set forth in the Relationship Summary Proposal. Additionally, although we understand that many dual-registrants and standalone broker-dealers, as a matter of best practice, already disclose capacity and types and scope of services to retail customers, for purposes of this analysis, we are assuming that dual-registrants would create new account disclosure related to capacity and all broker-dealers would create account disclosure related to types and scope of services specifically for purposes of compliance with Regulation Best Interest. The Commission assumes that broker-dealers would provide the account disclosure to each retail customer account, regardless of whether the retail customer has multiple accounts with the broker-dealer.

While the Commission recognizes that the Disclosure Obligation applies to the broker-dealer entity and its registered representatives, we do not expect

<sup>576</sup> The costs and burdens arising from the obligation to identify all material conflicts of interest that are associated with the recommendation are addressed above, in the context of the Conflict of Interest Obligation, in Section V.B.1.

registered representatives to incur any initial or ongoing burdens with respect to the capacity, scope and terms of the relationship, as we assume for purposes of this analysis that this information would be addressed by the broker-dealer entity's account disclosure. With regard to disclosure of capacity, the Commission believes that dually-registered representatives of broker-dealers would incur initial and ongoing burdens. Following is a discussion of the estimated initial and ongoing burdens and costs.

##### i. Initial Burdens and Costs

We estimate that a dually-registered firm would incur an initial internal burden of 10 hours for in-house counsel and in-house compliance personnel<sup>577</sup> to draft language regarding capacity for inclusion in the standardized account disclosure that is delivered to the retail customer.<sup>578</sup>

In addition, we estimate that dual-registrants would incur an estimated external cost of \$4,720 for the assistance of outside counsel in the preparation and review of standardized language regarding capacity.<sup>579</sup> For the estimated 360 dually-registered firms with retail business,<sup>580</sup> we project an aggregate initial burden of 3,600 hours,<sup>581</sup> and \$1.7 million in aggregate initial costs.<sup>582</sup>

Similarly, to comply with proposed Regulation Best Interest, standalone broker-dealers would likely draft standardized language for inclusion in the account disclosure to provide the retail customer with more specific information regarding the types and scope of services that they provide. We expect that the associated costs and burdens would differ between small and large broker-dealers, as large broker-dealers generally offer more products

<sup>577</sup> The 10 hour estimate includes 5 hours for in-house counsel to draft and review the standardized language, and 5 hours for consultation and review of compliance personnel.

<sup>578</sup> As discussed above, the following estimates include the burdens and costs that broker-dealers would incur in drafting standardized account disclosure language related to capacity, scope and terms of the relationship on behalf of their dually-registered representatives. For purposes of this analysis, the Commission assumes that broker-dealers would undertake these tasks on behalf of their registered representatives.

<sup>579</sup> This estimate is based on the following calculation: (10 hours for outside counsel review/drafting) × (\$472/hour for outside counsel services) = \$4,720 in initial outside counsel costs.

<sup>580</sup> See *supra* Section IV.B.1.a, at Table 1, Panel B.

<sup>581</sup> This estimate is based on the following calculation: (360 dually-registered retail firms) × (10 hours) = 3,600 initial aggregate burden hours.

<sup>582</sup> This estimate is based on the following calculation: (360 dually-registered retail firms) × (\$4,720 in external cost per firm) = \$1.7 million in aggregate initial costs.

<sup>575</sup> See Relationship Summary Proposal.



and services and therefore would need to potentially evaluate a larger number of products and services.

Given these assumptions, we estimate that a small broker-dealer would incur an internal initial burden of 10 hours for in-house counsel and in-house compliance personnel to draft this standardized language.<sup>583</sup> In addition, a small broker-dealer would incur an estimated external cost of \$4,720 for the assistance of outside counsel in the preparation and review of this standardized language.<sup>584</sup> For the estimated 802 small broker-dealers,<sup>585</sup> we project an aggregate initial burden of 8,020 hours,<sup>586</sup> and aggregate initial costs of \$3.79 million.<sup>587</sup>

Given the broader array of products and services offered, we estimate that a large broker-dealer would incur an internal burden of 20 hours to draft this standardized language.<sup>588</sup> A large broker-dealer would also incur an estimated cost of \$7,080 for the assistance of outside counsel in the preparation and review of this standardized language.<sup>589</sup> For the estimated 2,055 large retail broker-dealers, we estimate an aggregate initial burden of 41,100 hours,<sup>590</sup> and \$14.55 million in aggregate initial costs.<sup>591</sup>

We estimate that all broker-dealers would each incur approximately 0.02 burden hour<sup>592</sup> for delivery of the

account disclosure document.<sup>593</sup> Based on FOCUS data, we estimate that the 2,857 broker-dealers that report retail activity have approximately 128 million customer accounts, and that approximately 74.4%, or 95.2 million, of those accounts belong to retail customers.<sup>594</sup> We therefore estimate that broker-dealers would have an aggregate initial burden of 1,904,000 hours, or approximately 666 hours<sup>595</sup> per broker-dealer for the first year after the rule is in effect.<sup>596</sup>

We estimate a total initial aggregate burden for dually-registered, small and large broker-dealers to develop and deliver to retail customers account disclosures relating to capacity and type and scope of services of 1,956,620 burden hours.<sup>597</sup> We estimate a total initial aggregate cost of \$20.04 million.<sup>598</sup>

## ii. Ongoing Burdens

For purposes of this analysis, we assume that broker-dealers would review and amend the standardized language in the account disclosure, on average, once a year. Further, we

and 279 at 49259. We expect that delivery requirements will be performed by a general clerk. The general clerk's time is included in the initial burden estimate.

<sup>593</sup> As noted above, for new retail customers, we expect delivery to occur at the inception of the relationship; for existing customers, we expect delivery to occur prior to or at the time of a recommendation.

<sup>594</sup> The 2,857 broker-dealers (including dual registrants) with retail customers report 128 million customer accounts. See Section IV.B.1.a, Table 1, Panel B. Assuming the amount of retail customer accounts is proportionate to the percentage of broker-dealers that have retail customers, or 74.4% of broker-dealers, then the number of retail customer accounts would be 74.4% of 128 million accounts = 95.2 million retail customer accounts. This number likely overstates the number of deliveries to be made due to the double-counting of deliveries to be made by dual registrants to a certain extent, and the fact that one customer may own more than one account.

<sup>595</sup> These estimates are based on the following calculations: (0.02 hours per customer account × (95.2 million retail customer accounts) = 1,904,000 aggregate burden hours. Conversely, (1,904,000 hours)/(2,857 broker-dealers) = approximately 666 burden hours per broker-dealer.

<sup>596</sup> We estimate that broker-dealers will not incur any incremental postage costs because we assume that they will make such deliveries with another mailing the broker-dealer was already delivering to retail customers.

<sup>597</sup> This estimate is based on the following calculation: (3,600 aggregate initial burden hours for dual registrants) + (8,020 aggregate initial burden hours for small broker-dealers) + (41,000 burden hours for large broker-dealers) + (1,904,000 aggregate initial burden hours for all broker-dealers to deliver the account disclosures) = 1,956,620 total aggregate initial burden hours.

<sup>598</sup> This estimate is based on the following calculation: (\$1.7 million in initial aggregate costs for dual registrants) + (\$3.79 in initial aggregate costs for small broker-dealers) + (\$14.55 million in initial aggregate costs for large broker-dealers) = \$20.04 million in total initial aggregate costs.

assume that broker-dealers would not incur outside costs in connection with updating account disclosures, as in-house personnel would be more knowledgeable about changes in capacity, and the types and scope of services offered by the broker-dealer.

We estimate that each dually-registered broker-dealer would incur approximately five burden hours annually for compliance and business line personnel to review changes in the dual-registrant's capacity and types and scope of services offered, and another two burden hours annually for in-house counsel to amend the account disclosure to disclose material changes to the dual-registrant's capacity and types and scope of services offered, for a total of seven burden hours. The estimated ongoing aggregate burden to amend dual-registrants' account disclosures to reflect changes in capacity and types and scope of services would therefore be 2,520 hours.<sup>599</sup>

With respect to small standalone broker-dealers, we estimate an internal burden of two hours for in-house compliance and business line personnel to review and update changes in capacity and types or scope of services offered, and another two burden hours annually for in-house counsel to amend the account disclosure to disclose material changes to capacity and types or scope of services—for a total of four burden hours. The estimated ongoing aggregate burden for small broker-dealers to amend account disclosures to reflect changes in capacity and types and scope of services would therefore be 3,208 hours for small broker-dealers.<sup>600</sup>

We estimate that large standalone broker-dealers would incur 10 burden hours annually for in-house compliance and business line personnel to review and update changes in capacity and the types or scope of services offered, and another 10 burden hours annually for in-house counsel to amend the account disclosure to disclose material changes to capacity and the types and scope of services, for a total of 20 burden hours. We therefore believe the ongoing, aggregate burden would be 41,100 hours for large broker-dealers.<sup>601</sup>

With respect to delivery of the amended account agreements in the

<sup>599</sup> This estimate is based on the following calculation: (7 burden hours per dually-registered firm per year) × (360 dually-registered broker-dealers) = 2,520 ongoing aggregate burden hours.

<sup>600</sup> This estimate is based on the following calculation: (4 burden hours per broker-dealer per year) × (802 small broker-dealers) = 3,208 ongoing aggregate burden hours.

<sup>601</sup> This estimate is based on the following calculation: (20 burden hours per broker-dealer per year) × (2,055 large broker-dealers) = 41,100 ongoing aggregate burden hours.

<sup>583</sup> The 10 hour estimate includes 5 hours for in-house counsel to draft and review the standardized language, and 5 hours for consultation and review of compliance personnel.

<sup>584</sup> This estimate is based on the following calculation: (10 hours for outside counsel review/drafting) × (\$472/hour for outside counsel services) = \$4,720 in initial outside counsel costs.

<sup>585</sup> See *supra* note 538 and accompanying text.

<sup>586</sup> This estimate is based on the following calculation: (802 small broker-dealers) × (10 hours per small broker-dealer) = 8,020 aggregate burden hours.

<sup>587</sup> This estimate is based on the following calculation: (802 small broker-dealers) × (\$4,720 in external cost per small retail firm) = \$3.79 million in aggregate initial costs.

<sup>588</sup> The 20 hour estimate includes 10 hours for in-house counsel to draft and review the standardized language, and 10 hours for consultation and review of compliance personnel.

<sup>589</sup> This estimate is based on the following calculation: (15 hours for outside counsel review/drafting) × (\$472/hour for outside counsel services) = \$7,080 in initial outside counsel costs.

<sup>590</sup> This estimate is based on the following calculation: (2,055 large broker-dealers) × (20 burden hours) = 41,100 aggregate initial burden hours.

<sup>591</sup> This estimate is based on the following calculation: (2,055 large broker-dealers) × (\$7,080 initial outside counsel costs) = \$14.55 million in aggregate initial costs.

<sup>592</sup> This is the same estimate the Commission makes in the Relationship Summary Proposing Release. It is also the same estimate the Commission made in the Amendments to Form ADV Adopting Release, and for which we received no comment. See Amendments to Form ADV, 17 CFR parts 275

event of material changes to the capacity disclosure or disclosure related to types and scope of services, we estimate that this would take place among 20% of a broker-dealer's retail customer accounts annually. We therefore estimate broker-dealers to incur a total annual aggregate burden of 380,800 hours, or 133 hours per broker-dealer.<sup>602</sup>

The total ongoing aggregate burden for dually-registered, small and large broker-dealers to review, amend, and delivery updated account disclosures to reflect changes in capacity, types and scope of services would be 427,700 burden hours per year.<sup>603</sup>

The Commission acknowledges that the types of services and offering of products vary greatly by broker-dealer, and therefore that the costs or burdens associated with updating the account disclosure might similarly vary.

## (2) Disclosure of Fees

The Commission assumes for purposes of this analysis that a broker-dealer would disclose its fees and charges through a standardized fee schedule, delivered to the retail customer at the inception of the relationship, or, for existing retail customers, prior to or at the time of a recommendation and, as discussed below, would amend such fee schedules in the event of material changes. Although we understand that many broker-dealers already provide fee schedules to retail customers, we are assuming for purposes of this analysis that a fee schedule would be created specifically for purposes of compliance with Regulation Best Interest. While the Commission recognizes that the fee disclosure included in Disclosure Obligation applies to the broker-dealer entity and its natural associated persons, we do not expect any burdens or costs on registered representatives related to the fees and charges as this information would be addressed in the broker-dealer entity's fee schedule.

### i. Initial Costs/Burdens

We assume that, for purposes of this analysis, the associated costs and burdens would differ between small and

<sup>602</sup>  $(20\%) \times (95.2 \text{ million retail customer accounts}) \times (.02 \text{ hours for delivery to each customer account}) = 380,800 \text{ aggregate burden hours}$ . Conversely,  $380,800 \text{ aggregate burden hours} / 2,857 \text{ broker-dealers} = 133 \text{ burden hours per broker-dealer}$ .

<sup>603</sup> This estimate is based on the following calculation:  $(2,520 \text{ ongoing aggregate burden hours for dually-registered broker-dealers}) + (3,280 \text{ ongoing aggregate burden hours for small broker-dealers}) + (41,100 \text{ ongoing aggregate burden hours for large broker-dealers}) + (380,800 \text{ ongoing aggregate burden hours for delivery of amended account disclosures}) = 427,700 \text{ total ongoing aggregate burden hours}$ .

large broker-dealers, as large broker-dealers generally offer more products and services and therefore would need to potentially evaluate a wider range of fees in their fee schedules. As stated above, while we anticipate that many broker-dealers may already create fee schedules, we believe that small broker-dealers would initially spend five hours and large broker-dealers would spend ten hours to internally create a new fee schedule in consideration of the requirements of Regulation Best Interest. We additionally estimate a one-time external cost of \$2,360 for smaller broker-dealers<sup>604</sup> and \$4,720 for larger broker-dealers for outside counsel to review the fee schedule.<sup>605</sup> We therefore estimate the initial aggregate burden for small broker-dealers to be 4,010 burden hours,<sup>606</sup> and the initial aggregate cost to be \$1.89 million.<sup>607</sup> We estimate the aggregate burden for large broker-dealers to be 20,550 burden hours,<sup>608</sup> and the aggregate cost to be \$9.7 million.<sup>609</sup>

Similar to delivery of the account disclosure regarding capacity and types and scope of services, we estimate the burden for broker-dealers to make the initial delivery of the fee schedule to new retail customers, at the inception of the relationship, and existing retail customers, prior to or at the time of a recommendation, will require approximately 0.02 hours to deliver to each retail customer.<sup>610</sup> As stated above, we estimate that the 2,857 broker-dealers that report retail activity have approximately 128 million customer accounts, and that approximately 74.4%, or 95.2 million, of those accounts belong to retail customers.<sup>611</sup> We therefore estimate that a broker-dealer will have an aggregate initial burden of 380,800 hours, or approximately 133 hours per broker-

<sup>604</sup> This cost estimate is based on the following calculation:  $(5 \text{ hours of review}) \times (\$472/\text{hour for outside counsel services}) = \$2,360 \text{ outside counsel costs}$ .

<sup>605</sup> This cost estimate is based on the following calculation:  $(10 \text{ hours of review}) \times (\$472/\text{hour for outside counsel services}) = \$4,720 \text{ outside counsel costs}$ .

<sup>606</sup> This estimate is based on the following calculation:  $(5 \text{ burden hours of review per small broker-dealer}) \times (802 \text{ small broker-dealers}) = 4,010 \text{ aggregate initial burden hours}$ .

<sup>607</sup> This estimate is based on the following calculation:  $(\$2,360 \text{ for outside counsel costs per small broker-dealer}) \times (802 \text{ small broker-dealers}) = \$1.89 \text{ million in aggregate initial outside costs}$ .

<sup>608</sup> This estimate is based on the following calculation:  $(10 \text{ burden hours of review per large broker-dealer}) \times (2,055 \text{ large broker-dealers}) = 20,550 \text{ aggregate initial burden hours}$ .

<sup>609</sup> This estimate is based on the following calculation:  $(\$4,720 \text{ for outside counsel costs per large broker-dealer}) \times (2,055 \text{ large broker-dealers}) = \$9.70 \text{ million in aggregate initial costs}$ .

<sup>610</sup> See *supra* note 592.

<sup>611</sup> See *supra* note 593.

dealer for the first year after the rule is in effect.<sup>612</sup>

The total aggregate initial burden for broker-dealers is therefore estimated at 405,360<sup>613</sup> hours, and the total aggregate initial cost is estimated at \$11.59 million.<sup>614</sup>

### ii. Ongoing Costs/Burdens

For purposes of this PRA analysis, we assume that broker-dealers would review and amend the fee schedule on average, once a year. With respect to small broker-dealers, we estimate that it would require approximately two hours per year to review and update the fee schedule, and for large broker-dealers, we estimate that the recurring, annual burden to review and update the fee schedule would be four hours for each large broker-dealer. Based on these estimates, we estimate the recurring, aggregate, annualized burden would be approximately 1,604 hours for small broker-dealers<sup>615</sup> and 8,220 hours for large broker-dealers.<sup>616</sup> We do not anticipate that small or large broker-dealers would incur outside legal, compliance, or consulting fees in connection with updating their standardized fee schedule since in-house personnel would be more knowledgeable about these facts, and we therefore do not expect external costs associated with updating the fee schedule.

With respect to delivery of the amended fee schedule in the event of a material change, we estimate that this would take place among 40% of a broker-dealer's retail customer accounts annually. We therefore estimate broker-dealers would incur a total annual aggregate burden of 761,600 hours, or 267 hours per broker-dealer.<sup>617</sup>

<sup>612</sup> This estimate is based on the following calculation:  $(20\%) \times (95.2 \text{ million retail customer accounts}) \times (.02 \text{ hours for delivery to each customer account}) = 380,800 \text{ aggregate burden hours}$ . Conversely,  $(380,800 \text{ aggregate burden hours}) / (2,857 \text{ broker-dealers}) = 133 \text{ burden hours per broker-dealer}$ .

<sup>613</sup> This estimate is based on the following calculations:  $(4,010 \text{ aggregate burden hours for small broker-dealers}) + (20,550 \text{ burden hours for large broker-dealers}) + (380,800 \text{ burden hours for delivery}) = 405,360 \text{ total aggregate initial burden hours}$ .

<sup>614</sup> This estimate is based on the following calculation:  $(\$1.89 \text{ million for small broker-dealer costs}) + (\$9.7 \text{ million large broker-dealer costs}) = \$11.59 \text{ million in total aggregate costs}$ .

<sup>615</sup> This estimate is based on the following calculation:  $(2 \text{ burden hours per broker-dealer}) \times (802 \text{ small broker-dealers}) = 1,604 \text{ aggregate burden hours}$ .

<sup>616</sup> This estimate is based on the following calculation:  $(4 \text{ burden hours per broker-dealer}) \times (2,055 \text{ large broker-dealers}) = 8,220 \text{ aggregate burden hours}$ .

<sup>617</sup> This estimate is based on the following calculation:  $(40\% \text{ of } 95.2 \text{ million retail customer}$

The Commission acknowledges that the type of fee schedule may vary greatly by broker-dealer, and therefore that the costs or burdens associated with updating the standardized fee schedule might similarly vary.

### (3) Disclosure of Material Conflicts of Interest

Regulation Best Interest would require broker-dealers to reasonably disclose all material conflicts that are associated with a recommendation. Because the Disclosure Obligation applies to both broker-dealers entity and registered representatives, the Commission expects that the broker-dealer entity and its registered representatives would incur initial and ongoing burdens. However, as with the disclosure of capacity and types and scope of services, we assume for purposes of this analysis that broker-dealers would incur the burdens and costs of disclosing material conflicts of interest on behalf of their registered representatives.

#### i. Initial Costs and Burdens

The Disclosure Obligation of proposed Regulation Best Interest would provide broker-dealers with the flexibility to choose the form and manner of conflict disclosure. However, we believe that many or most broker-dealers would develop a standardized conflict disclosure document and distribute it to retail customers.<sup>618</sup> We also assume for purposes of this PRA analysis that broker-dealers would update and deliver the standardized conflict disclosure document yearly on an ongoing basis, following the broker-dealer's annual conflicts review process.<sup>619</sup>

For purposes of this PRA analysis, we assume that a standardized conflict disclosure document would be developed by in-house counsel and reviewed by outside counsel. For small broker-dealers, we estimate it would take in-house counsel, on average, 5 burden hours to create the standardized conflict disclosure document and outside counsel 5 hours to review and

accounts)  $\times$  (.02 hours) = 761,600 aggregate burden hours. Conversely, (761,600 aggregate burden hours)/(2,857 broker-dealers) = 267 burden hours per broker-dealer.

<sup>618</sup> As noted above, we assume that delivery for new customers would occur at the inception of the relationship, and that delivery for existing customers would occur prior to or at the time a recommendation is made.

<sup>619</sup> However, as discussed above, we recognize that broker-dealers might choose to disclose material conflicts of interest on an as-needed basis, and might take a layered approach to disclosure, as opposed to a standardized conflict disclosure document. We request comment on whether broker-dealers may choose to take a layered approach to disclosure and the associated costs of burdens.

revise the document. The initial aggregate burden for the development of a standardized disclosure document, based on an estimated 802 small broker-dealers, would be approximately 4,010 burden hours.<sup>620</sup> We additionally estimate an initial cost of \$2,360 per small broker-dealer,<sup>621</sup> and an aggregate initial cost of \$1.89 million for all small broker-dealers.<sup>622</sup>

We expect the development and review of the standardized conflict disclosure document to take longer for large broker-dealers because, as discussed above, we believe large broker-dealers generally offer more products and services and employ more individuals, and therefore would need to potentially disclose a larger number of conflicts. We estimate that for large broker-dealers, it would take 7.5 burden hours for in-house counsel to create the standardized conflict disclosure document, and outside counsel would take another 7.5 hours to review and revise the disclosure document. As a result, we estimate the initial aggregate burden, based on an estimated 2,055 large broker-dealers, to be approximately 15,413 burden hours.<sup>623</sup> We additionally estimate initial costs of \$3,540 per broker-dealer,<sup>624</sup> and an aggregate cost for large broker-dealers of approximately \$7.27 million.<sup>625</sup>

We assume that broker-dealers would deliver the standardized conflict disclosure document to new retail customers at the inception of the relationship, and to existing retail customers prior to or at the time of a recommendation. We estimate that broker-dealers would require approximately 0.02 hours to deliver the standardized conflict disclosure document to each retail customer.<sup>626</sup> We therefore estimate that broker-dealers would incur an aggregate initial burden of 1,904,000 hours, or approximately 666 hours per broker-dealer for delivery

<sup>620</sup> This estimate is based on the following calculation: (5 hours)  $\times$  (802 small broker-dealers) = 4,010 aggregate burden hours.

<sup>621</sup> This estimate is based on the following calculation: (\$472/hour)  $\times$  (5 hours) = \$2,360 in initial costs.

<sup>622</sup> This estimate is based on the following calculation: (\$472/hour  $\times$  5 hours)  $\times$  (802 broker-dealers) = \$1.89 million in aggregate initial costs.

<sup>623</sup> This estimate is based on the following calculation: (7.5 hours  $\times$  2,055 large broker-dealers) = 15,413 burden hours.

<sup>624</sup> This estimate is based on the following calculation: (\$472/hour)  $\times$  (7.5 hours) = \$3,540 in initial costs.

<sup>625</sup> This estimate is based on the following calculation: (\$472/hour)  $\times$  (7.5 hours  $\times$  2,055 large broker-dealers) = \$7.27 million in aggregate costs.

<sup>626</sup> See *supra* note 592. For purposes of this PRA analysis, we have assumed any initial disclosures made by the broker-dealer related to material conflicts of interest would be delivered together.

of the standardized conflict disclosure document the first year after the rule is in effect.<sup>627</sup>

#### ii. Ongoing Costs and Burdens

We believe that broker-dealers would incur ongoing annual burdens and costs to update the disclosure document to include newly identified conflicts. While Regulation Best Interest does not require broker-dealers to provide disclosures at specific intervals or times, but rather allows broker-dealers to provide disclosures on an as-needed basis, we assume for purposes of this analysis that broker-dealers would update their conflict disclosure document annually, after conducting an annual conflicts review. We estimate that the conflict disclosure form would be updated internally by both small and large broker-dealers.

We estimate that in-house counsel at a small broker-dealer would require approximately 1 hour per year to update the standardized conflict disclosure document, for an ongoing aggregate burden of approximately 802 hours.<sup>628</sup> For large broker-dealers, we estimate that the ongoing, annual burden would be 2 hours for each broker-dealer: 1 hour for compliance personnel and 1 hour for legal personnel. We therefore estimate the ongoing, aggregate burden for large broker-dealers to be approximately 4,110 burden hours.<sup>629</sup> We do not anticipate that small or large broker-dealers would incur outside legal, compliance, or consulting fees in connection with updating their standardized conflict disclosure document, since in-house personnel would presumably be more knowledgeable about conflicts of interest.

With respect to ongoing delivery of the updated conflict disclosure document, we estimate that this would take place among 40% of a broker-dealer's retail customer accounts annually.<sup>630</sup> We therefore estimate that broker-dealers would incur an aggregate

<sup>627</sup> These estimates are based on the following calculations: (0.02 hours per customer account  $\times$  95.2 million retail customer accounts) = 1,904,000 aggregate burden hours. Conversely, (1,904,000 hours)/(2,857 broker-dealers) = 666 burden hours per broker-dealer.

<sup>628</sup> This estimate is based on the following calculation: (1 hour per broker-dealer)  $\times$  (802 small broker-dealers) = 802 aggregate burden hours.

<sup>629</sup> This estimate is based on the following calculation: (2 hours per broker-dealer)  $\times$  (2,055 large broker-dealers) = 4,110 aggregate burden hours.

<sup>630</sup> The Commission estimates that broker-dealers would update fees and material conflicts of interest disclosure more frequently than disclosure related to capacity or type and scope of services.

ongoing burden of 761,600 hours, or 267 burden hours per broker-dealer.<sup>631</sup>

### 3. Care Obligation

Under proposed Regulation Best Interest, prior to or at the time of making the recommendation, a broker-dealer would be required to make a reasonable effort to ascertain the potential risks and rewards associated with the recommendation, and to determine whether the recommendation could be in the best interest of at least some retail customers. However, any PRA burdens or costs associated with the Care Obligation are discussed below with respect to proposed Rule 17a-3(a)(25).

### 4. Record-Making and Recordkeeping Obligations

Records made and retained in accordance with the proposed amendments to Rule 17a-3(a)(25) and 17a-4(e)(5) would (1) assist a broker-dealer in supervising and assessing internal compliance with Regulation Best Interest; and (2) assist the Commission and SRO staff in connection with examinations and investigations.

The record-making and recordkeeping costs and burdens associated with the proposed amendments to Rule 17a-3(a)(25) and Rule 17a-4(e)(5) are addressed below.

#### a. Record-Making

Proposed Rule 17a-3(a)(25) would require a broker-dealer to make a record of all information collected from and provided to the retail customer pursuant to Proposed Regulation Best Interest. We understand that broker-dealers currently make records of relevant customer investment profile information, and we therefore assume that no additional record-making obligations would arise as a result of broker-dealers' or their registered representatives' collection of information from retail customers.<sup>632</sup>

<sup>631</sup> This estimate is based on the following calculation: (40% of 95.2 million retail customer accounts) × (.02 hours) = 761,600 aggregate burden hours. Conversely, (761,600 aggregate burden hours)/(2,857 broker-dealers) = 267 hours per broker-dealer.

<sup>632</sup> The PRA burdens and costs arising from the requirement that a record be made of all information provided to the retail customer are accounted for in proposed Regulation Best Interest and the Relationship Summary Proposal. With respect to the requirement that a record be made of all information from the retail customer, we believe that proposed Rule 17a-3(a)(25) would not impose any new substantive burdens on broker-dealers. As discussed above, we believe that the obligation to exercise reasonable diligence, care, skill and prudence would not require a broker-dealer to collect additional information from the retail customer beyond that currently collected in the ordinary course of business even though a broker-dealer's analysis of that information and any

in addition, the proposed amendment to Rule 17a-3(a)(25) would require a broker-dealer, "for each retail customer to whom a recommendation of any securities transaction or investment strategy involving securities is or will be provided," to make a record of the "identity of each natural person who is an associated person, if any, responsible for the account." We understand that broker-dealers likely make such records in the ordinary course of their business pursuant to Exchange Act Rules 17a-3(a)(6) and (7). However, we are assuming, for purposes of compliance with proposed Rule 17a-3(a)(25), that broker-dealers would need to create a record, or modify an existing record, to identify the associated person, if any, responsible for the account in the context of proposed Regulation Best Interest.

#### (1) Initial Costs and Burdens

We assume that broker-dealers would satisfy the record-making requirement of the proposed amendment to Rule 17a-3(a)(25) by amending an existing account disclosure document to include this information. We believe that the inclusion of this information in an account disclosure document would require, on average, approximately 1 hour per year for outside counsel at small broker-dealers, at an average rate of \$472/hour, for an annual cost of \$472 for each small broker-dealer to update an account disclosure document. The projected initial, aggregate cost for small broker-dealers would be \$378,544.<sup>633</sup> For broker-dealers that are not small entities, we estimate that the initial burden would be 2 hours for each broker-dealer: 1 hour for compliance personnel and 1 hour for legal personnel. We therefore believe the initial aggregate burden for broker-dealers that are not small entities would be approximately 4,110 burden hours.<sup>634</sup> Finally, we estimate it would require an additional 0.04 hours for the registered representative responsible for the information (or other clerical personnel) to fill out that information in the account disclosure document, for an approximate total aggregate initial burden of 3,808,000 hours, or approximately 1,333 hours per broker-dealer for the first year after the rule is

resulting recommendation would need to adhere to the enhanced best interest standard of Regulation Best Interest. See *supra* Section I.L.D.2.

<sup>633</sup> This estimate is based on the following calculation: (1 hour per small broker-dealer) × (802 small broker-dealers) × (\$472/hour) = \$378,544 in aggregate costs.

<sup>634</sup> This estimate is based on the following calculation: (2 burden hours per broker-dealer) × (2,055 large broker-dealers) = 4,110 aggregate burden hours.

in effect.<sup>635</sup> Because we have already included the costs and burdens associated with the delivery of the amended account disclosure document above, we need not include them in this section of the analysis.

#### (2) Ongoing Costs and Burdens

We do not believe that the identity of the registered representative responsible for the retail customer's account would change. Accordingly, we believe that there are no ongoing costs and burdens associated with this record-making requirement of the proposed amendment to Rule 17a-3(a)(25).

#### b. Recordkeeping Obligations

For each record made pursuant to proposed Rule 17a-3(a)(25), the proposed amendment to Rule 17a-4(e)(5) would require broker-dealers to retain "all account record information required pursuant to [Regulation Best Interest] and all records required pursuant to [Regulation Best Interest], in each case until at least six years after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated." As discussed above, the following records would likely need to be retained pursuant to proposed Rule 17a-3(a)(25): (1) A standardized Relationship Summary document, developed in accordance with the rules and guidance contained in the Relationship Summary Proposal; (2) existing account disclosure documents; (3) a comprehensive fee schedule; and (4) disclosures identifying material conflicts.

#### (1) Initial Costs and Burdens

We believe that, to reduce costs and for ease of compliance, broker-dealers would utilize their existing recordkeeping systems in order to retain the forgoing records made pursuant to Regulation Best Interest, and as required to be kept under the Proposed Amendment to Rule 17a-4(e)(5). As noted above, broker-dealers currently are subject to recordkeeping obligations pursuant to Rule 17a-4, which require, for example, broker-dealers to "preserve for a period of not less than six years, the first two years in an easily accessible place, all records required to be made pursuant to" Rule 17a-3(a)(1), (a)(2), (a)(3), (a)(5), (a)(21), (a)(22), and analogous records created pursuant to paragraph 17a-3(f). Thus, for example,

<sup>635</sup> These estimates are based on the following calculations: (0.04 hours per customer account) × (95.2 million retail customer accounts) = 3,808,000 aggregate burden hours. Conversely, (3,808,000 burden hours)/(2,857 broker-dealers) = 1,333 hours per broker-dealer.

broker-dealers are already required to maintain documents such as account blotters and ledgers for six years.

We believe that broker-dealers would leverage their existing recordkeeping systems to include any additional or amended records required by Regulation Best Interest or pursuant to Proposed Amendment to Rule 17a-4(e)(5), and would similarly leverage their existing recordkeeping systems to account for any differences in the retention period. Thus, where broker-dealers currently retain documents on an electronic database to satisfy existing Rule 17a-4 or otherwise, we would expect broker-dealers to maintain any additional documents required by Regulation Best Interest or Proposed Amendment to Rule 17a-4(e)(5) by the same means. Likewise, where broker-dealers maintain documents required by existing Rule 17a-4 by paper, we would expect broker-dealers to continue to do so.

Based on the assumption that broker-dealers will rely on existing infrastructures to satisfy the recordkeeping obligations of Regulation Best Interest and Proposed Amendment to Rule 17a-4(e)(5), we believe the burden for broker-dealers to add new documents or modify existing documents to the broker-dealer's existing retention system would be approximately 15.9 million burden hours for all broker-dealers, assuming a broker-dealer would need to upload or file each of the five account documents discussed above for each retail customer account.<sup>636</sup> We do not believe there would be additional internal or external costs relating to the uploading or filing of the documents, nevertheless, we request comment on this assumption and whether the new requirements would pose additional costs, for example, relating to storage space for paper or relating to additional electronic database storage space. In addition, because we have already included the costs and burdens associated with the delivery of the amended account opening agreement and other documents above, we do not include them in this section of the analysis.

## (2) Ongoing Costs and Burdens

We estimate that the approximate ongoing burden associated with the recordkeeping requirement of proposed amendment to Rule 17a-4(e)(5) is 3.17

<sup>636</sup> This estimate is based on the following calculation: (5 documents per customer account) × (95.2 million retail customer accounts) × (2 minutes per document) / 60 minutes = 15,866,667 aggregate burden hours.

million burden hours per year.<sup>637</sup> We do not believe that the ongoing costs associated with ensuring compliance with the retention schedule would change from the current costs of ensuring compliance with existing Rule 17a-4 and as outlined above. However, we request comment regarding both the frequency with which a broker-dealer would need to collect, provide, replace, or update the records made pursuant to the proposed amendment to Rule 17a-3(a)(25), and also on whether there would be additional costs relating to ensuring compliance with record retention and retention schedules pursuant to Rule 17a-4.

### C. Collection of Information Is Mandatory

The collections of information relating to: (1) "Regulation Best Interest;" (2) the Proposed Amendment to Rule 17a-3—Records to be Made by Certain Exchange Members, Brokers and Dealers (OMB control number 3235-0033); and (3) the Proposed Amendment to Rule 17a-4—Records to be Preserved by Certain Brokers and Dealers (OMB control number 3235-0279) are mandatory for all broker-dealers.

### D. Confidentiality

With respect to written disclosure provided to the retail customer as required by Regulation Best Interest, such disclosure would not be kept confidential. Other information provided to the Commission in connection with staff examinations or investigations would be kept confidential, subject to the provisions of applicable law.

### E. Request for Comment

The Commission is using the above estimates for the purposes of calculating reporting burdens associated with Regulation Best Interest, the Proposed Amendment to Rule 17a-3 and the Proposed Amendment to Rule 17a-4. We request comment on our estimates for the new and recurring burdens and associated costs described above in connection with Regulation Best Interest. In addition to the request for comments made throughout this Section V, the Commission more generally seeks comment on its estimates as to: (1) The

<sup>637</sup> This estimate is based on the percentage of account records we expect would be updated each year as described in Section V.B.2, *supra*, and the following calculation: (40% of fee schedules × 95.2 million retail customer accounts) × (2 minutes per document) + (40% of conflict disclosure forms × 95.2 million retail customer accounts) × (2 minutes per document) + (20% of account opening documents × 95.2 million retail customer accounts) × (2 minutes per document) = 3,173,334 aggregate burden hours.

number of natural persons who are associated persons; (2) the number of broker-dealers that make securities-related recommendations to retail customers; (3) the number of natural persons who are associated persons that make securities-related recommendations to retail customers; and (4) any other costs or burdens associated with Regulation Best Interest that have not been identified in this release.

The Commission additionally invites comment on any other issues related to the costs and burdens associated with Regulation Best Interest. Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comment in order to:

- Evaluate whether the proposed collection of information is necessary for the performance of our functions, including whether the information will have practical utility;
- evaluate the accuracy of our estimates of the burdens of the proposed collections of information;
- determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and
- evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of Regulation Best Interest should direct them to (1) the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of FOIA Services, Washington, DC 20503; and (2) Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090, with reference to File No. S7-XX-XX. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, with reference to File No. S7-XX-XX, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street NE, Washington, DC 20549-0213. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

## VI. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of

1996, or “SBREFA,”<sup>638</sup> the Commission must advise the OMB as to whether the proposed regulation constitutes a “major” rule. Under SBREFA, a rule is considered “major” where, if adopted, it results or is likely to result in:

- An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease);
  - a major increase in costs or prices for consumers or individual industries; or
  - significant adverse effect on competition, investment or innovation.
- If a rule is “major,” its effectiveness will generally be delayed for 60 days pending Congressional review.

The Commission requests comment on the potential impact of Regulation Best Interest and the Proposed Amendment to Rule 17a-4(e)(5) on:

- The U.S. economy on an annual basis,
- Any potential increase in costs or prices for consumers or individual industries, and
- Any potential effect on competition, investment, or innovation.

Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

## VII. Initial Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act (“RFA”)<sup>639</sup> requires federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)<sup>640</sup> of the Administrative Procedure Act,<sup>641</sup> as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on “small entities.”<sup>642</sup> Under Section 605(b) of the RFA, a federal agency need not undertake a regulatory flexibility analysis of proposed rules where, if adopted, they would not have a significant economic impact on a substantial number of small entities.<sup>643</sup>

<sup>638</sup> Public Law 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

<sup>639</sup> 5 U.S.C. 601 *et seq.*

<sup>640</sup> 5 U.S.C. 603(a).

<sup>641</sup> 5 U.S.C. 551 *et seq.*

<sup>642</sup> Although Section 601(b) of the RFA defines the term “small entity,” the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term small entity for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0–10 under the Exchange Act, 17 CFR 240.0–10.

<sup>643</sup> See 5 U.S.C. 605(b).

### A. Reasons for and Objectives of the Proposed Action

As discussed above in Section I, the Commission is proposing Regulation Best Interest to establish a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. While broker-dealers are subject to extensive existing obligations, there is no specific obligation under the Exchange Act that broker-dealers make recommendations that are in their customers’ best interest. The Commission believes it is appropriate to make enhancements to the obligations that apply when broker-dealers make recommendations to retail customers.

The proposed standard of conduct is to act in the best interest of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker-dealer or natural person who is an associated person making the recommendation ahead of the interest of the retail customer. This obligation shall be satisfied if: The broker-dealer or a natural person who is an associated person of a broker-dealer, before or at the time of such recommendation reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship, and all material conflicts of interest associated with the recommendation; the broker-dealer or a natural person who is an associated person of a broker-dealer, in making the recommendation, exercises reasonable diligence, care, skill, and prudence; the broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations; and the broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

The Commission’s objectives in proposing Regulation Best Interest are to: (1) Enhance the quality of recommendations provided by broker-dealers to retail customers, by establishing under the Exchange Act a “best interest” care obligation that encompasses and goes beyond existing broker-dealer suitability obligations under the federal securities laws and

that cannot be satisfied through disclosure alone,<sup>644</sup> and further establishing obligations under the Exchange Act that require mitigation, and not just disclosure, of conflicts of interest arising from financial incentives, and thus helps to reduce the potential harm resulting from such conflicts; (2) help retail customers evaluate recommendations received from broker-dealers, as well as address confusion regarding the broker-dealer relationship structure, by improving the disclosure of information regarding broker-dealer conflicts of interest and the material facts relating to scope and terms of the relationship with the retail customer; (3) facilitate more consistent regulation of substantially similar activity, particularly across retirement and non-retirement assets held at broker-dealers, and in this manner help to reduce investor confusion; (4) better align the legal obligations of broker-dealers with investors’ reasonable expectations; and (5) help preserve investor choice and access to affordable investment advice and products that investors currently use. Each of these objectives is discussed in more detail in Section I.B., *supra*.

Furthermore, the proposed addition of paragraph (a)(25) to Rule 17a-3 would impose new record-making obligations on broker-dealers subject to Regulation Best Interest,<sup>645</sup> while the Proposed Amendment to Rule 17a-4(e)(5) would impose new record retention obligations on broker-dealers subject to Regulation Best Interest.<sup>646</sup>

### B. Legal Basis

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act Section 913(f), Public Law 111–203, 124 Stat. 1376, 1827 (2010), and Exchange Act sections 3, 10, 15, 17, 23 and 36 thereof, 15 U.S.C. 78c, 78j, 78o, 78q, 78w and 78mm, the Commission is

<sup>644</sup> See *supra* note 7.

<sup>645</sup> As described in Section II.E. *supra*, the Commission is proposing to amend Rule 17a-3 to add a new paragraph (a)(25), which would 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 Regulation Best Interest, as well as the identity of each natural person who is an associated person of a broker or dealer, if any, responsible for the account.

<sup>646</sup> As described in Section II.E. *supra*, the Commission is proposing to amend Exchange Act Rule 17a-4(e)(5) to require broker-dealers to retain a record of all information collected from and provided to the retail customer pursuant to Rule 17a-3(a)(25), in addition to the existing requirement to retain information obtained pursuant to Rule 17a-3(a)(17). As a result, broker-dealers would be required to retain all of the information collected from or provided to each retail customer pursuant to Regulation Best Interest for six years.

proposing to adopt § 240.15–1, to amend § 240.17a–3 by adding new paragraph (a)(25), and to revise § 240.17a–4(e)(5) of Title 17 of the Code of Federal Regulations.

### C. Small Entities Subject to the Proposed Rule

For purposes of a Commission rulemaking in connection with the RFA, a broker-dealer will be deemed a small entity if it: (1) Had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d) under the Exchange Act,<sup>647</sup> or, if not required to file such statements, had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization.<sup>648</sup>

As discussed in Section V, *supra*, the Commission estimates that approximately 2,857 retail broker-dealers would be subject to Regulation Best Interest and the proposed amendment to Rules 17a–3 and 17a–4. Based on FOCUS Report data,<sup>649</sup> the Commission estimates that as of December 31, 2017, approximately 802 of those retail broker-dealers might be deemed small entities for purposes of this analysis.<sup>650</sup> For purposes of this RFA analysis, we refer to broker-dealers that might be deemed small entities under the RFA as “small entities,” and we continue to use the term “broker-dealers” to refer to broker-dealers generally, as the term is used elsewhere in this release.<sup>651</sup>

### D. Projected Compliance Requirements of the Proposed Rule for Small Entities

The RFA requires a description of the projected reporting, recordkeeping, and other compliance requirements of proposed Regulation Best Interest and the proposed rule and rule amendments to Rules 17a–3(a)(25) and 17a–4(e)(5), including an estimate of the classes of small entities that will be subject to the

requirements and the type of professional skill necessary to prepare required reports and records. Following is a discussion of the associated costs and burdens of compliance with proposed Regulation Best Interest, as incurred by small entities.

#### 1. Conflict of Interest Obligations

As described more fully above in Section V.D.1., the Conflict of Interest Obligations would generally include the obligation to: (1) Update written policies and procedures to comply with Regulation Best Interest; (2) identify material conflicts of interest; and (3) develop a training program to maintain and enforce the policies and procedures that promote compliance with Regulation Best Interest.<sup>652</sup>

##### a. Written Policies and Procedures

To initially comply with this obligation, we believe that small entities would primarily rely on outside counsel to update existing policies and procedures. We believe that the initial costs associated with this for small entities would be \$18,880 per small entity (reflecting an estimated 40 hours of outside legal counsel services), and an aggregate cost of \$15.1 million for all small entities.<sup>653</sup> We additionally believe in-house legal counsel would require 10 hours to review and approve the updated policies and procedures, for an aggregate burden of 8,020 hours.<sup>654</sup> We preliminarily believe that the related ongoing costs for small entities (relating to reviewing and updating policies and procedures on a periodic basis outside) would be \$3,850<sup>655</sup> annually for each small entity, and the projected ongoing, aggregate annualized cost for small entities (relating to outside legal counsel and outside compliance consulting services) would be \$3.08 million.<sup>656</sup> In addition, we believe that small entities would incur approximately five hours internal burden for in-house compliance manager to review and approve the updated policies and procedures per year, for an aggregate annual burden of 4,010 hours for all small entities.<sup>657</sup>

#### b. Identification of Material Conflicts of Interest

To identify whether a material conflict of interest exists in connection with a recommendation, a small entity would need to establish mechanisms to proactively and systematically identify conflicts of interest in its business on an ongoing or periodic basis.<sup>658</sup>

Acknowledging that costs and burdens may vary greatly according to the size of the small entity, we expect that the modification of a small entity’s existing technology would initially require the retention of an outside programmer, and that the modification of existing technology would require, on average, an estimated 20 hours of the programmer’s labor, for an estimated cost per small entity of \$5,400.<sup>659</sup> We additionally project that coordination between the senior programmer and the small entity’s compliance manager would involve five burden hours. The aggregate costs and burdens on small entities for the modification of existing technology to identify conflicts of interest would therefore be \$4.33 million,<sup>660</sup> and 4,010 burden hours.<sup>661</sup>

We additionally believe that the determination whether the conflicts of interest, once identified, are material, would require approximately five hours per small entity,<sup>662</sup> for an aggregate total of 4,010 burden hours for small entities.<sup>663</sup>

To maintain compliance with Regulation Best Interest, we expect that a broker-dealer should seek to identify additional conflicts as its business evolves. We estimate that a small entity’s business line and compliance personnel would jointly spend, on average, 10 hours<sup>664</sup> to perform an annual conflicts review using the modified technology infrastructure. Therefore the aggregate, ongoing burden for an annual conflicts review, based on an estimated 802 small entities, would be approximately 8,020 burden hours.<sup>665</sup>

<sup>658</sup> See *supra* Section V.B.1.b.(1).

<sup>659</sup> See *supra* note 560.

<sup>660</sup> This cost estimate is based on the following calculation: (20 hours of review) × (\$270/hour for technology services) × (802 small entities) = \$4.33 million.

<sup>661</sup> This burden estimate is based on the following calculation: (5 burden hours) × (802 small entities) = 4,010 burden hours.

<sup>662</sup> See *supra* note 563.

<sup>663</sup> This burden estimate is based on the following calculation: (5 burden hours) × (802 small entities) = 4,010 burden hours.

<sup>664</sup> See *supra* note 567.

<sup>665</sup> This estimate is based on the following calculation: (10 hours of labor per retail broker-dealer) × 802 small entities = 8,020 burden hours. The Commission recognizes that the types of services and product offerings vary greatly by broker-dealer. See *supra* Section V.D.1.b(2).

<sup>647</sup> See 17 CFR 240.17a–5(d).

<sup>648</sup> See 17 CFR 240.0–10(c).

<sup>649</sup> See note 538, *supra*.

<sup>650</sup> According to the FOCUS data, there are 1,040 broker-dealers that might be deemed small entities, but only 77% of those small entities (802 firms) have retail business and would be subject to Regulation Best Interest and the proposed amendments to Rules 17a–3 and 17a–4.

<sup>651</sup> Consistent with the PRA, unless otherwise noted, we use the terms “registered representative” and “dually registered representative of a broker-dealer” herein. See *supra* note 534.

<sup>652</sup> For a discussion of additional costs and burdens, as well as monetized burdens, related to the Conflict of Interest Obligation, see *supra* Section IV.C.2.d.

<sup>653</sup> See *supra* notes 545 and 546.

<sup>654</sup> See *supra* note 547.

<sup>655</sup> This estimate is based on the following calculation: (\$2,360 for five hours of outside legal counsel review) + (\$1,490 for five hours of outside compliance consulting services) = \$3,850. See *supra* notes 551 and 553, and accompanying text.

<sup>656</sup> See *supra* note 555.

<sup>657</sup> See *supra* note 556.

### c. Training

Proposed Regulation Best Interest would also require a small entity to maintain and enforce its written policies and procedures. Toward this end, we expect small entities to develop training programs that promote compliance with Regulation Best Interest among registered representatives. We assume that small entities would likely use a computerized training module to train registered representatives. We estimate that a small entity would retain an outside systems analyst, an outside programmer, and an outside programmer analyst to create the training module, at 20 hours, 40 hours, and 20 hours, respectively.<sup>666</sup> The total cost for a small entity to develop the training module would be approximately \$21,600,<sup>667</sup> for an aggregate cost of \$17.32 million.<sup>668</sup>

Additionally, we expect that the training module would require the approval of the Chief Compliance Officer, as well as in-house legal counsel, each of whom we expect would require approximately 2 hours to review and approve the training module.<sup>669</sup> The aggregate burden for small entities would be estimated at 3,208 burden hours.<sup>670</sup>

In addition, small entities would incur an initial start-up cost for registered representatives to undergo training through the training module. We estimate the training time at one hour per registered representative, for a total aggregate burden of 4,236 burden hours.<sup>671</sup>

We assume that small entities would likely require registered representatives to repeat the training module for Regulation Best Interest on an annual basis. The ongoing aggregate cost for the one-hour training would be 4,236 burden hours per year.<sup>672</sup>

### 2. Disclosure Obligations

Pursuant to the Disclosure Obligations of proposed Regulation Best Interest, a small entity would need to: (1) Reasonably disclose to the retail

customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer (including, at a minimum, disclosure of capacity, fees and charges, and types and scope of services); and (2) reasonably disclose to the retail customer, in writing, all material conflicts of interest that are associated with the recommendation. The estimated costs and burdens incurred by small entities in relation to these Disclosure Obligations are discussed in detail below.<sup>673</sup>

#### a. Disclosure of Capacity, Type and Scope of Services

We estimate that dually-registered small entities would incur an initial internal burden of ten hours for in-house counsel and in-house compliance personnel to draft language regarding capacity for inclusion in the standardized account disclosure that is delivered to the retail customer.<sup>674</sup> In addition, dual-registrants would incur an estimated external cost of \$4,720 for the assistance of outside counsel in the preparation and review of this standardized language.<sup>675</sup> For the estimated 41 dually-registered small entities with retail business,<sup>676</sup> we project an aggregate initial burden of 410 hours,<sup>677</sup> and \$193,520 in initial external costs.<sup>678</sup>

Similarly, we estimate that small entities would incur an initial burden of ten hours for in-house counsel and in-house compliance personnel to draft this standardized language.<sup>679</sup> In addition, small entities would incur an estimated external cost of \$4,720 for the assistance of outside counsel in the preparation and review of this standardized language.<sup>680</sup> For the estimated 802 small entities, we project an aggregate initial burden of 8,020 hours,<sup>681</sup> and an initial aggregate \$3.79 million in costs.<sup>682</sup>

We estimate that small entities would each incur approximately 0.02 burden hour for delivery of the account

disclosure document.<sup>683</sup> Based on FOCUS data, we believe that the 802 small entities that report retail activity have a total of 10,545 customer accounts, and that approximately 74.4%, or 7,845, of those accounts belong to retail customers.<sup>684</sup> We therefore estimate that small entities would incur an aggregate initial burden of 156.9 hours,<sup>685</sup> with each small entity incurring an initial burden of 0.2 hour for the first year after the rule is in effect.

On an ongoing basis, we estimate that small entities would review and amend the standardized language in the account disclosure, on average, once a year. Further, we assume that such amendments would likely be minimal.

We estimate that each dually-registered small entity would spend approximately five hours annually for compliance and business line personnel to review changes in its capacity and types and scope of services offered, and another two hours annually for in-house counsel to amend the account disclosure to disclose material changes to the broker-dealer's capacity and types and scope of services offered, for a total of seven hours. The estimated ongoing aggregate burden would therefore 287 hours for small entity dual-registrants capacity.<sup>686</sup>

With respect to small entity standalone broker-dealers, we estimate they would spend two for in-house compliance and business personnel to review and update changes in capacity or the types or scope of services offered, and we estimate another two hours annually for in-house counsel to amend the account disclosure to disclose material changes to capacity or the types or scope of services for small entities—for a total of four hours. The estimated ongoing aggregate burden would therefore be 3,208 hours for small

<sup>683</sup> See *supra* note 593.

<sup>684</sup> See *supra* note 594. Assuming the percentage of retail customer accounts at small broker-dealers is consistent with the percentage of retail customer accounts at all broker-dealers, then the number of retail customer accounts would be 74.4% of 10,545 accounts = 7,845 accounts. This number might overstate the number of deliveries to be made due to the double-counting of deliveries to be made by dual registrants to a certain extent, and the fact that one customer may own more than one account.

<sup>685</sup> This estimate is based on the following calculation: (.02 hour) × (7,845 retail customer accounts) = 156.9 hours (aggregate)/802 small entities = 0.2 hour per small entity. We estimate that small entities will not incur any incremental postage costs because we assume that they will make such deliveries with another mailing the broker-dealer was already delivering to customers.

<sup>686</sup> This estimate is based on the following calculation: (7 hours per small entity per year) × (41 dually-registered small entities) = 287 hours.

<sup>673</sup> For a discussion of additional costs and burdens, as well as monetized burdens, related to the Disclosure Obligation, see *supra* Section IV.C.2.b.

<sup>674</sup> See *supra* note 577 and 578.

<sup>675</sup> See *supra* note 579.

<sup>676</sup> This estimate is based on FOCUS data. See *supra* note 538.

<sup>677</sup> This estimate is based on the following calculation: (41 dually-registered small entities) × (10 burden hours) = 410 aggregate burden hours.

<sup>678</sup> This estimate is based on the following calculation: (41 dually-registered small entities) × (\$4,720 in costs per small entity) = \$193,520 in aggregate initial costs.

<sup>679</sup> See *supra* note 583.

<sup>680</sup> See *supra* note 584.

<sup>681</sup> See *supra* note 586.

<sup>682</sup> See *supra* note 587.

<sup>666</sup> See *supra* Section V.B.1.c.(1).

<sup>667</sup> See *supra* note 569.

<sup>668</sup> This estimate is based on the following calculation: (802 small entities) × (\$21,600 cost per broker-dealer) = \$17.32 million.

<sup>669</sup> See *supra* Section V.B.1.c.(1).

<sup>670</sup> This estimate is based on the following calculation: (802 small entities) × (4 burden hours per small entity) = 3,208 burden hours.

<sup>671</sup> This estimate is based on the following calculation: (1 burden hour) × (4,236 registered representatives at small entities) = 4,236 burden hours. See *supra* note 572.

<sup>672</sup> This estimate is based on the following calculation: (1 burden hour) × (4,236 registered representatives at small entities) = 4,236 burden hours.



entities for types and scope of services.<sup>687</sup>

With respect to delivery of the amended account agreements in the event of material changes to the capacity disclosure or disclosure related to type and scope of services, we estimate that this would take place among 20% of a small entity's retail customer accounts annually. We therefore estimate that small entities would incur an aggregate burden of 313.8 hours,<sup>688</sup> or .39 hours per small entity.<sup>689</sup>

#### b. Disclosure of Fees

As stated above, we believe that small entities would initially spend five hours to internally create a new fee schedule in consideration of the requirements of Regulation Best Interest. We additionally estimate a one-time external cost of \$2,360 for small entities for outside counsel to review the fee schedule.<sup>690</sup> We therefore estimate the initial aggregate burden for small entities to be 4,010 burden hours,<sup>691</sup> and the aggregate cost to be \$1.89 million.<sup>692</sup>

Similar to delivery of the account disclosure document related to capacity and types and scope of services, we estimate the burden for small entities to make the initial delivery of the fee schedule to new retail customers, at the inception of the relationship, and existing retail customers, prior to or at the time of a recommendation, will require approximately 0.02 hour to deliver to each retail customer.<sup>693</sup> As stated above, we estimate that the 802 small entities that report retail activity have approximately 7,845 retail customer accounts. We estimate that small entities will have an aggregate initial burden of 156.9 hours,<sup>694</sup> or a burden of approximately 0.19 hour per small entity for the first year after the rule is in effect.<sup>695</sup>

We also assume that small entities would review and amend the fee schedule, on average, once a year. We estimate that each small entity would require approximately two hours per

year to review and update the fee schedule. Based on this estimate, we project the recurring, aggregate, annualized burden to be approximately 1,604 hours for small entities.<sup>696</sup> We do not anticipate that small entities would incur outside legal, compliance, or consulting fees in connection with updating their standardized fee schedule since in-house personnel would be more knowledgeable about these facts, and therefore do not expect external costs associated with updating the fee schedule.

With respect to delivery of the amended fee schedule in the event of a material change, we estimate that this would take place among 40% of a small entity's retail customer accounts annually. We therefore estimate that small entities would incur a total annual aggregate burden of 62.76 hours, or 0.07 hour per small entity.<sup>697</sup>

#### c. Disclosure of Material Conflicts of Interest

For purposes of this analysis, we assume that small entities would use in-house counsel and outside counsel to develop a standardized conflict disclosure document for delivery to retail customers. We estimate it would take in-house counsel for small entities, on average, 5 burden hours to create the standardized disclosure document, and that outside counsel would require 5 hours to review and revise the standardized disclosure document. The initial aggregate burden for the development of a standardized disclosure document, based on an estimated 802 small entities, would be approximately 4,010 burden hours.<sup>698</sup> The initial external cost for a small entity is estimated at \$2,360 per small entity.<sup>699</sup> The aggregate, initial external cost for the development of a standardized conflict disclosure document, based on an estimated 802 small entities, would be approximately \$1.89 million.<sup>700</sup>

We assume that small entities would initially deliver the standardized conflict disclosure document to new retail customers at the inception of the relationship, and to existing retail customers prior to or at the time of a

recommendation. We estimate that small entities would require approximately 0.02 hours to deliver the standardized conflict disclosure document to each retail customer.<sup>701</sup> We therefore estimate that small entities would incur an aggregate initial burden of 156.9 hours<sup>702</sup> for delivery of the standardized conflict disclosure document, or 0.19 hour per small entity.

On an ongoing basis, we believe that small entities would incur burdens and costs to update the standardized conflict disclosure document to include newly identified conflicts annually. We assume small entities would rely on in-house counsel and in-house compliance personnel to update the disclosure document. We do not anticipate that small entities would incur outside legal, compliance, or consulting costs in connection with updating the disclosure document, since in-house personnel would presumably be more knowledgeable about material conflicts of interest.

We estimate that small entities would require approximately 1 hour per year, for a recurring, aggregate burden of approximately 802 hours per year<sup>703</sup> to update the standardized conflict disclosure document.

With respect to the ongoing costs and burdens of delivering the amended conflict disclosure document, we estimate that this would take place among 40% of a small entity's retail customer accounts annually.<sup>704</sup> We therefore estimate that small entities would incur an annual aggregate burden of 62.76 burden hours, or 0.07 burden hour per small entity.<sup>705</sup>

### 3. Obligation To Exercise Reasonable Diligence, Care, Skill and Prudence

As discussed above in Section V.B.3., we believe that the obligation to exercise reasonable diligence, care, skill and prudence in making a

<sup>701</sup> See *supra* note 592. We have assumed any initial disclosures made by the small entity related to material conflicts of interest would be delivered together, and therefore have not included delivery costs for initial delivery.

<sup>702</sup> This estimate is based on the following calculation: (0.02 hour) × (7,845 retail customer accounts at small entities) = 156.9 aggregate burden hours. Conversely, (156.9 burden hours)/(802 small entities) = 0.19 burden hour per small entity.

<sup>703</sup> This estimate is based on the following calculation: (1 hour per small entity) × (802 small entities) = 802 aggregate burden hours.

<sup>704</sup> The Commission estimates that small entities would update disclosures regarding fees and material conflicts of interest more frequently than the disclosure related to capacity or type and scope of services.

<sup>705</sup> This estimate is based on the following calculation: (40% of 7,845 retail customer accounts at small entities) × (0.02 hours) = 62.76 burden hours. Conversely, (62.76 burden hours)/(802 small entities) = 0.07 hour per small entity.

<sup>687</sup> See *supra* note 600.

<sup>688</sup> This estimate is based on the following calculation: (20%) × (7,845 total small entity retail customer accounts) × (.02 hours) = 313.8 hours.

<sup>689</sup> This estimate is based on the following calculation: (313.8 hours aggregate)/802 small entity broker-dealers = 0.39 hour.

<sup>690</sup> See *supra* note 604.

<sup>691</sup> See *supra* note 606.

<sup>692</sup> See *supra* note 607.

<sup>693</sup> See *supra* note 592.

<sup>694</sup> This estimate is based on the following calculation: (.02 hour per account) × (7,845 total small entity retail customer accounts) = 156.9 hours.

<sup>695</sup> These estimates are based on the following calculations: (156.9 aggregate hours)/802 small broker-dealers = 0.19 hours per small broker-dealer.

<sup>696</sup> See *supra* note 615.

<sup>697</sup> 40% of 7,845 retail customer accounts × .02 hours = 62.76 aggregate hours. (62.76 hours)/(802 broker-dealers) = 0.07 hour per broker-dealer.

<sup>698</sup> This estimate is based on the following calculation: (5 hours) × (802 small entities) = 4,010 aggregate burden hours.

<sup>699</sup> This estimate is based on the following calculation: (\$472/hour) × (5 hours) = \$2,360 in costs.

<sup>700</sup> This estimate is based on the following calculation: (\$472/hour × 5 hours) × (802 small entities) = \$1.89 million in aggregate costs.

recommendation would not impose additional costs or burdens on small entities.<sup>706</sup>

#### 4. Record-Making and Recordkeeping Obligations

Small entities' record-making and recordkeeping costs and burdens associated with the proposed amendments to Rule 17a-3(a)(25) and Rule 17a-4(e)(5) are addressed below.<sup>707</sup>

##### a. Record-Making Obligations

Proposed Rule 17a-3(a)(25) would require a broker-dealer (including small entities) to make a record of all information collected from and provided to the retail customer pursuant to Proposed Regulation Best Interest. We understand that small entities currently make records of relevant customer investment profile information, and we therefore assume that no additional record-making obligations would arise as a result of small entities' collection of information from retail customers.<sup>708</sup>

In addition, the proposed amendment to Rule 17a-3(a)(25) would require a small entity, "for each retail customer to whom a recommendation of any securities transaction or investment strategy involving securities is or will be provided," to make a record of the "identity of each natural person who is an associated person, if any, responsible for the account." We understand that small entities likely make such records in the ordinary course of their business pursuant to Exchange Act Rules 17a-3(a)(6) and (7). However, we are assuming, for purposes of compliance with proposed Rule 17a-3(a)(25), that broker-dealers would need to create a record, or modify an existing record, to identify the associated person, if any, responsible for the account in the context of proposed Regulation Best Interest.

We believe that small entities would satisfy the record-making requirement of the proposed amendment to Rule 17a-3(a)(25) by amending an existing account disclosure document to include this information. We believe that the

<sup>706</sup> For a discussion of additional costs and burdens, as well as monetized burdens, related to the Care Obligation, see *supra* Section IV.C.2.c.

<sup>707</sup> For a discussion of additional costs and burdens, as well as monetized burdens, related to Record-making and Recordkeeping, see *supra* Section IV.C.2.c.

<sup>708</sup> As discussed above, we believe that the obligation to exercise reasonable diligence, care, skill and prudence would not require a small entity to collect additional information from the retail customer beyond that currently collected in the ordinary course of business, although a small entity's analysis of that information and any resulting recommendation would need to adhere to the enhanced best interest standard of Regulation Best Interest. See *supra* Section II.D.2.

inclusion of this information in the account disclosure document would require, on average, approximately 1 hour per year for outside counsel at small entities, at an average rate of \$472/hour, for an annual cost of \$472 for each small entity. The projected initial aggregate cost for small entities would be \$378,544.<sup>709</sup> Finally, we estimate it would require an additional 0.04 hour for the registered representative responsible for the account (or other clerical personnel) to fill out that information in the account disclosure document, for an estimated total aggregate initial burden of 313.8 hours, or approximately 0.39 hour per small entity for the first year after the rule is in effect.<sup>710</sup> Because we have already included the costs and burdens associated with the delivery of the account disclosure document above, we need not include them in this section of the analysis.

We do not believe that the identity of the associated person responsible for the retail customer's account would change. Accordingly, there are no ongoing costs and burdens associated with this record-making requirement of the proposed amendment to Rule 17a-3(a)(25).

##### b. Recordkeeping Obligations

As described in more detail in Section V.B.4., the following records would likely need to be retained for "six years after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated" pursuant to proposed Rule 17a-3(a)(25): (1) A standardized Relationship Summary document, developed in accordance with the rules and guidance contained in the Relationship Summary Proposal; (2) account disclosure documents; (3) comprehensive fee schedule; and (4) disclosures identifying material conflicts.

We believe that small entities would utilize existing recordkeeping systems in order to retain the records made pursuant to Regulation Best Interest, as required under the Proposed Amendment to Rule 17a-4(e)(5). We believe the initial burden for small entities to add new documents or modified documents to their existing retention systems would be

<sup>709</sup> This estimate is based on the following calculation: (1 hour per small entity) × (802 small entities) × (\$472/hour) = \$378,544 in aggregate costs.

<sup>710</sup> These estimates are based on the following calculations: (0.04 hour per customer account) × (7,845 customer accounts) = 313.8 aggregate burden hours. Conversely, (313.8 aggregate burden hours) / (802 small entities) = approximately 0.39 hour per small entity.

approximately 1,307.5 hours.<sup>711</sup> We do not believe there would be initial costs relating to the uploading or filing of the documents.<sup>712</sup>

We estimate that the approximate ongoing burden associated with the proposed amendment to Rule 17a-4(e)(5) would be 261.5 burden hours per year for small entities.<sup>713</sup> As explained above, we do not believe the ongoing costs associated with the proposed amendment to Rule 17a-4(e)(5) would change from small entities' current costs of compliance with existing Rule 17a-4.<sup>714</sup>

#### E. Duplicative, Overlapping, or Conflicting Federal Rules

An analysis under the RFA requires a federal agency to identify, to the extent practicable, all relevant federal rules that may duplicate, overlap or conflict with the proposed rule. As discussed above, the existing regulatory regime for broker-dealers includes the DOL Fiduciary Rule and related PTEs, in particular, the obligations that the BIC Exemption and the Principal Transactions Exemption would impose.<sup>715</sup> However, we believe that the principles underlying Regulation Best Interest would not conflict with and are generally consistent with the principles underlying the DOL's approach under the DOL Fiduciary Rule and the related PTEs, specifically the BIC Exemption and the Principal Transactions Exemption.

#### F. Significant Alternatives

An RFA analysis requires a discussion of alternatives to the proposed rule that would minimize the impact on small entities while accomplishing the stated

<sup>711</sup> This estimate is based on the following calculation: (5 documents per retail customer account) × (7,845 retail customer accounts at small entities) × (2 minutes per document) = 78,450 minutes/60 minutes = 1,307.5 burden hours. See *supra* note 636.

<sup>712</sup> As noted above, we request comment on this assumption and whether the new requirements would pose additional costs.

<sup>713</sup> This estimate is derived from the percentage of records that we expect to be updated annually, as described in Section V.B.2. above, and based on the following calculation: (40% of fee schedules × 7,845 retail customer accounts) × (2 minutes per document) + (40% of conflict disclosures × 7,845 retail customer accounts) × (2 minutes per document) + (20% of account opening documents × 7,845 retail customer accounts) × (2 minutes per document) = 7,845 minutes/60 minutes = 261.5 burden hours.

<sup>714</sup> As noted above, we request comment regarding both the frequency with which a broker-dealer would need to collect, provide, replace or update the records made pursuant to the proposed amendment to Rule 17a-3(a)(25), and also whether there would be additional costs relating to ensuring compliance with the record retention and retention schedules pursuant to Rule 17a-4.

<sup>715</sup> See, e.g., *supra* Sections I.A.2, II.B.1.a.

objectives of the applicable statutes. The analysis should include: (1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rule, or any part thereof, for such small entities.

The Commission preliminarily does not believe that exempting any subset of broker-dealers, including broker-dealers that are small entities, from proposed Regulation Best Interest and the proposed amendments to Rules 17a–3 and 17a–4(e)(5) would permit us to achieve our stated objectives. We also do not believe it would be desirable to establish different requirements applicable to broker-dealers of different sizes to account for resources available to small entities.

As discussed above, we believe that the proposal would result in multiple investor protection benefits, and these benefits should apply to retail customers of smaller entities as well as retail customers of large broker-dealers. For example, a primary objective of this proposal is to enhance the quality of recommendations provided by broker-dealers to retail customers, by establishing under the Exchange Act a “best interest” obligation. We do not believe that the interest of investors who are retail customers would be served by exempting broker-dealers that are small entities from proposed Regulation Best Interest and the proposed amendments to Rules 17a–3 and 17a–4(e)(5) or subjecting these broker-dealers to different requirements than larger broker-dealers.<sup>716</sup>

Moreover, providing an exemption or different requirements for small entities would be inconsistent with our goal of facilitating more consistent regulation, in recognition of the importance for both investors and broker-dealers of having the applicable standards for brokerage recommendations be clear, understandable, and as consistent as possible across a brokerage relationship (*i.e.*, whether for retirement or non-retirement purposes) and better aligned

<sup>716</sup> See, *e.g.*, PIABA Letter (“Firms overcharge investors, recommend higher fee share classes, recommend replacements of existing mutual funds and annuities, and recommend complex products with opaque fee structures. This conduct is not limited to one sector of the brokerage industry—it occurs in firms both large and small. Note further that the violations carry across the broad spectrum of investment types.”).

with other advice relationships (*e.g.*, a relationship with an investment adviser).<sup>717</sup> Further, as discussed above, broker-dealers are subject to regulation under the Exchange Act and the rules of each SRO of which the broker-dealer is a member, including a number of obligations that attach when a broker-dealer makes a recommendation to a customer, as well as general and specific requirements aimed at addressing certain conflicts of interest. We note that these existing requirements do not generally distinguish between small entities and other broker-dealers.

For the same reasons, we do not believe that the clarification, consolidation, or simplification of compliance and reporting requirements would be appropriate for small entities. We note, however, in crafting proposed Regulation Best Interest, we generally aimed to provide broker-dealers flexibility in determining how to satisfy the component obligations. For example, under proposed Regulation Best Interest, broker-dealers would have the flexibility to establish systems that are tailored to their business models, and to focus on specific areas of their business that pose the greatest risk of violating the Conflict of Interest Obligations. For instance, small entities without conflicting business interests would require much simpler policies and procedures than large broker-dealers that, for example, have multiple potential conflicts as a result of their other lines of business or their affiliations with other financial service firms.<sup>718</sup> Similarly, by not mandating the form, specific timing, or method for delivering disclosure pursuant to the Disclosure Obligation, we aim to provide broker-dealers flexibility in determining how to satisfy the Disclosure Obligation depending on each broker-dealer’s business practices, consistent with the principles set forth *supra* Section II.D.1.c, and in line with the suggestion of some commenters that stressed the importance of allowing broker-dealers to select the form and manner of delivery of disclosure.<sup>719</sup> We believe that this flexibility reflects a general performance-based approach,

<sup>717</sup> See *supra* note 80 and accompanying text.

<sup>718</sup> See *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2204 (Dec. 17, 2003), available at <https://www.sec.gov/divisions/investment/advoverview.htm>. See also RAND Study (reporting that the more numerous smaller firms tended to provide a more limited and focused range of either investment advisory or brokerage services, and the larger firms tended to engage in a much broader range of products and services, offering both investment advisory and brokerage services).

<sup>719</sup> See *supra* note 206.

rather than design-based approach in the proposal.

The Commission also considered a number of potential regulatory alternatives to proposed Regulation Best Interest, including: (1) A disclosure-only alternative; (2) a principles-based standard of conduct obligation; (3) a fiduciary standard for broker-dealers; and (4) an enhanced standard akin to conditions of the BIC Exemption. For a more detailed discussion of these regulatory alternatives, see Section IV.E., *supra*.

#### 1. Disclosure-Only Alternative

As an alternative, the Commission could have only the Disclosure Obligation, whereby broker-dealers would be obligated to disclose all material facts and conflicts.<sup>720</sup> Under this alternative, the overall costs to small entities to comply with the requirements of the rule would be larger than those associated with currently required disclosure for broker-dealers in general, and such entities; however, the costs to comply would likely be lower relative to proposed Regulation Best Interest.

For a number of reasons, the Commission preliminarily believes that a rule that only required the disclosure of conflicts of interest would be less effective than the proposed rule because broker-dealers (including small entities) would not be required to act in the best interest of their customers when making recommendations, including by complying with the specific components of the Care Obligation and mitigating material conflicts of interest arising from financial incentives, and it would therefore be less effective at providing retail customer protection and reducing potential investor harm than proposed Regulation Best Interest.<sup>721</sup>

#### 2. Principles-Based Alternative

As an alternative, the Commission could rely on a principles-based standard of conduct, which could be developed by each broker-dealer based on their business model without directly requiring conduct standards.<sup>722</sup> A principles-based standard of conduct would provide increased flexibility for small entities to tailor their

<sup>720</sup> As described more fully in Section IV.E., *supra*, under the disclosure-only alternative, the proposed Relationship Summary and Regulatory Status Disclosure could serve as key components of any additional disclosure that would be required under the disclosure-only alternative.

<sup>721</sup> See *supra* Section IV.E.

<sup>722</sup> As discussed above, under a principles-based care obligation, broker-dealers would be required to continue to comply with the existing regulatory baseline, including disclosure obligations under the antifraud provisions of federal securities laws.

recommendations to retail customers and could impose lower compliance costs on broker-dealers, including small entities, relative to the requirements of the proposed rule. This approach would also reflect an approach that is even more performance-based than the current proposal, as it would be less prescriptive.

For the reasons described in this Section VI. above and in Section IV.E., the Commission preliminarily believes that any regulatory approach should provide a clear understanding of what a best interest standard would entail to a level set across broker-dealers and that a principles-based standard of conduct approach only, would be less effective from a retail customer protection standpoint than proposed Regulation Best Interest.<sup>723</sup> Further, we preliminarily believe that a principles-based approach could increase liability costs for broker-dealers, including small entities, as a result of lack of clarity in the standard.

### 3. Enhanced Standards Akin to BIC Exemption

The Commission could alternatively propose a fiduciary standard coupled with a series of disclosure and other requirements akin to the full complement of conditions of the DOL's BIC Exemption, which would apply to broker-dealers (including small entities) when making investment recommendations to all types of retail accounts rather than only in connection with services to retirement accounts.<sup>724</sup>

We recognize that there could be reduced economic effects for broker-dealers (including small entities) that may already have established infrastructure for purposes of the DOL's BIC Exemption. However, an alternative that would impose upon broker-dealers a fiduciary standard coupled with a set of requirements akin to the BIC Exemption conditions could drive up costs to retail customers of obtaining investment advice from broker-dealers, and could cause some retail customers to forgo advisory services through broker-dealers if they were priced out of the market.<sup>725</sup>

As a result, and for a number of other reasons described above, the Commission preliminarily believes that requiring broker-dealers to comply with a fiduciary standard coupled with a set of requirements akin to the full complement of conditions under the BIC Exemption could impose costs to

broker-dealers (including small entities) and impact retail customers and the market for investment advice, and would not be entirely consistent with the regulatory approach of the Commission.<sup>726</sup>

### G. General Request for Comment

For the foregoing reasons, the Commission preliminarily believes that Regulation Best Interest might have a significant economic impact on a substantial number of small entities for purposes of the RFA. The Commission encourages written comments regarding this initial regulatory flexibility analysis. The Commission specifically solicits comment on the number of small entities that may be affected by Regulation Best Interest, and whether Regulation Best Interest would have an effect on small entities that has not been considered. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact. We also request comment on the proposed compliance burdens and the effects these burdens would have on smaller entities.

### VIII. Statutory Authority and Text of Proposed Rule

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act Section 913(f), Public Law 111–203, 124 Stat. 1376, 1827 (2010), and Exchange Act sections 3, 10, 15, 17, 23 and 36 thereof, 15 U.S.C. 78c, 78j, 78o, 78q, 78w and 78mm, the Commission is proposing to adopt § 240.15l–1, to amend § 240.17a–3 by adding new paragraph (a)(25), and to revise § 240.17a–4(e)(5) of Title 17 of the Code of Federal Regulations in the manner set forth below.

#### List of Subjects in 17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

#### Text of the Proposed Rules

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

### PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 1. The general authority citation for part 240 continues to read as follows and sectional authorities for section 240.15l–1 are added to read as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn,

77sss, 77ttt, 78c, 78c–3, 78c–5, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78n–1, 78o, 78o–4, 78o–10, 78p, 78q, 78q–1, 78s, 78u–5, 78w, 78x, 78dd, 78ll, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, 7201 *et seq.*, and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; Pub. L. 111–203, 939A, 124 Stat. 1887 (2010); and secs. 503 and 602, Pub. L. 112–106, 126 Stat. 326 (2012), unless otherwise noted.

\* \* \* \* \*

Section 240.15l–1 is also issued under Pub. L. 111–203, sec. 913, 124 Stat. 1376, 1827 (2010).

\* \* \* \* \*

■ 2. Add § 240.15l–1 to read as follows:

#### § 240.15l–1 Regulation Best Interest.

(a) *Best Interest Obligation.* (1) A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, shall 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, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.

(2) The best interest obligation in paragraph (a)(1) shall be satisfied if:

(i) *Disclosure Obligation.* The broker, dealer, or natural person who is an associated person of a broker or dealer, prior to or at the time of such recommendation, reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer, including all material conflicts of interest that are associated with the recommendation.

(ii) *Care Obligation.* The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation exercises reasonable diligence, care, skill, and prudence to:

(A) Understand the potential risks and rewards 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;

(B) 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 and rewards associated with the recommendation; and

(C) Have a reasonable basis to believe that a series of recommended transactions, even if in the retail

<sup>723</sup> See *supra* Section IV.E.

<sup>724</sup> *Id.*

<sup>725</sup> See, e.g., note 75 *supra*, and accompanying text. *But see*, notes 76–77, and accompanying text.

<sup>726</sup> *Id.*

customer's best 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.

(iii) *Conflict of Interest Obligations.*

(A) The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations.

(B) The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

(b) *Definitions.* Unless otherwise provided, all terms used in this rule shall have the same meaning as in the [Securities Exchange Act of 1934]. In addition, the following definitions shall apply:

(1) *Retail Customer* means 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.

(2) *Retail Customer Investment Profile* includes, but is not limited to, the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation.

■ 3. Amend § 240.17a-3 by adding new paragraph (a)(25) to read as follows:

**§ 240.17a-3 Records to be made by certain exchange members, brokers and dealers.**

(a) \* \* \*

(25) For each retail customer to whom a recommendation of any securities transaction or investment strategy involving securities is or will be provided:

(i) A record of all information collected from and provided to the retail customer pursuant to § 240.15l-1, as well as the identity of each natural person who is an associated person, if any, responsible for the account.

(ii) For purposes of this paragraph (a)(25), the neglect, refusal, or inability of the retail customer to provide or update any information required under paragraph (a)(25)(i) of this section shall excuse the broker, dealer, or associated person from obtaining that required information.

\* \* \* \* \*

■ 4. Amend § 240.17a-4 by revising paragraph (e)(5) to read as follows:

**§ 240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.**

\* \* \* \* \*

(e) \* \* \*

(5) All account record information required pursuant to § 240.17a-3(a)(17) and all records required pursuant to § 240.17a-3(a)(25), in each case until at least six years after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated.

\* \* \* \* \*

By the Commission.

Dated: April 18, 2018.

**Brent J. Fields,**  
*Secretary.*

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