



# RISK ALERT

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

April 7, 2020

## Examinations that Focus on Compliance with Regulation Best Interest

**In this Alert:** *Examinations related to Regulation Best Interest.*

**Key Takeaways:** *After the compliance date, OCIE staff intends to engage in examinations to assess broker-dealers' implementation and operational effectiveness of Regulation Best Interest.*

### I. Introduction

The Office of Compliance Inspections and Examinations (“OCIE”)<sup>1</sup> is issuing this Risk Alert to provide broker-dealers with information about the scope and content of initial examinations after the compliance date for Regulation Best Interest.<sup>2</sup> Regulation Best Interest establishes a new standard of conduct under the Exchange Act for broker-dealers and associated persons of a broker-dealer (collectively “broker-dealers” or “firms”).<sup>3</sup> When making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer,<sup>4</sup> a broker-dealer must act in the best interest of the retail customer at the time the recommendation is made, without placing its

own financial or other interest ahead of the retail customer’s interest.<sup>5</sup> This general obligation is satisfied only if a broker-dealer complies with four component obligations: a Disclosure Obligation, a Care Obligation, a Conflict of Interest Obligation, and a Compliance Obligation.<sup>6</sup>

After the compliance date, OCIE will begin examinations to assess implementation of Regulation Best Interest. These initial examinations, which will likely occur during the first year after the compliance date, are designed primarily to evaluate whether firms have established policies and procedures reasonably designed to achieve compliance with Regulation Best Interest. OCIE will also evaluate whether firms have made reasonable progress in implementing those policies and procedures as necessary or appropriate, including making such modifications

<sup>1</sup> This Risk Alert represents the views of the staff of OCIE. It is not a rule, regulation, or statement of the U.S. Securities and Exchange Commission (“Commission”). The Commission has neither approved nor disapproved its content. This Risk Alert, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

<sup>2</sup> On June 5, 2019, the Commission adopted Rule 15l-1 (“Regulation Best Interest”) under the Securities Exchange Act of 1934 (“Exchange Act”), which has a compliance date of June 30, 2020. Exchange Act Release No. 86031 (June 5, 2019) (“Regulation Best Interest Adopting Release”). Additional information on Regulation Best Interest, including frequently asked questions, is available at: <https://www.sec.gov/regulation-best-interest>.

<sup>3</sup> Regulation Best Interest Adopting Release at 19.

<sup>4</sup> A “retail customer” is “a natural person, or the legal representative of such natural person, who: (A) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (B) uses the recommendation primarily for personal, family, or household purposes.” Exchange Act Rule 15l-1(b)(1).

<sup>5</sup> Exchange Act Rule 15l-1(a)(1).

<sup>6</sup> Exchange Act Rule 15l-1(a)(2).

as may be necessary or appropriate, in light of information gained from the implementation process and other facts and circumstances.

OCIE stands ready to work with firms and our colleagues in the Division of Trading and Markets on issues that may arise in the course of examinations and understands that the coronavirus disease 2019 (COVID-19) has created challenges for firms.<sup>7</sup>

This Risk Alert is not intended to be an explanation of the requirements of Regulation Best Interest. Firms are encouraged to familiarize themselves with the specific requirements of Regulation Best Interest by reviewing the [Regulation Best Interest Adopting Release](#) and the [Small Entity Compliance Guide](#).<sup>8</sup> Questions regarding Regulation Best Interest may be directed to: [IABDQuestions@sec.gov](mailto:IABDQuestions@sec.gov).

## II. Examinations for Compliance with Regulation Best Interest

Initial examinations will focus on assessing whether firms have made a good faith effort to implement policies and procedures reasonably designed to comply with Regulation Best Interest, including the operational effectiveness of broker-dealers' policies and procedures. Examples of areas the staff may focus on are discussed below.

- **Disclosure Obligation.** The Disclosure Obligation requires a broker-dealer, prior to or at the time of the recommendation, to provide a retail customer, in writing, full and fair disclosure of:
  - all material facts relating to the scope and terms of the relationship with the retail customer; and
  - all material facts relating to conflicts of interest that are associated with the recommendation.<sup>9</sup>

Specific Disclosures. Staff may assess how the firm has met the Disclosure Obligation's requirement to disclose material facts relating to the scope and terms of the relationship, including: (i) the capacity in which the recommendation is being made, (ii) material fees and costs that apply to the retail customer's transactions, holdings, and accounts, and (iii)

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<sup>7</sup> While the Commission and staff across Commission divisions and offices continue to monitor the effects of COVID-19 on market participants, including broker-dealers, the Commission has not extended the compliance date for Regulation Best Interest. OCIE staff remains fully operational nationwide and continues to execute its investor protection mission. See OCIE Statement on Operations and Exams (Mar. 23, 2020), available at: <https://www.sec.gov/ocie/announcement/ocie-statement-operations-health-safety-investor-protection-and-continued>.

<sup>8</sup> The Regulation Best Interest Adopting Release is available at: <https://www.sec.gov/rules/final/2019/34-86031.pdf>; the Small Entity Compliance Guide is available at: <https://www.sec.gov/info/smallbus/secg/regulation-best-interest>.

<sup>9</sup> Exchange Act Rule 15l-1(a)(2)(i) ("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, provides the retail customer, in writing, full and fair disclosure of: (A) All material facts relating to the scope and terms of the relationship with the retail customer, including: (1) That the broker, dealer, or such natural person is acting as a broker, dealer, or an associated person of a broker or dealer with respect to the recommendation; (2) The material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and (3) The type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer; and (B) All material facts relating to conflicts of interest that are associated with the recommendation.").

material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer.

Document Requests. To assess compliance with this obligation, staff may review the content of the disclosures, and other firm records, to determine if the disclosures provide the required information to retail customers. Staff may also review the timing of the disclosures. Staff may review documents such as:

- Schedules of fees and charges assessed against retail customers and disclosures regarding such fees and charges, including disclosures regarding the fees and costs related to services and investments that retail customers will pay or incur directly and indirectly (*e.g.*, custodian fees, account maintenance fees, fees related to mutual funds and variable annuities, and other transactional fees and product-level fees);
  - The broker-dealer's compensation methods for registered personnel, including (i) compensation associated with recommendations to retail customers, (ii) sources and types of compensation (*e.g.*, direct payments by an investor, payments by a product sponsor), and (iii) related conflicts of interest (*e.g.*, conflicts associated with recommending proprietary products or with receiving payments for inclusion on a product menu);
  - Disclosures related to monitoring of retail customers' accounts;
  - Disclosures on material limitations on accounts or services recommended to retail customers; and
  - Lists of proprietary products sold to retail customers.
- **Care Obligation.** The Care Obligation requires a broker-dealer to exercise reasonable diligence, care, and skill when making a recommendation to a retail customer. The broker-dealer must understand potential risks, rewards, and costs associated with the recommendation. The broker-dealer must then consider these factors in light of the retail customer's investment profile and make a recommendation that is in the retail customer's best interest.<sup>10</sup>

Document Requests. To assess compliance with this obligation, staff may review:

- Information collected from retail customers to develop their investment profiles (including any new account forms, correspondence, and any agreements the customer has with the broker-dealer).
- The broker-dealer's process for having a reasonable basis to believe that the recommendations are in the best interest of the retail customer (which may

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<sup>10</sup> Exchange Act Rule 15l-1(a)(2)(ii) ("The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation, exercises reasonable diligence, care, and skill to: (A) Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (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, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and (C) 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 and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.").

include, *e.g.*, any process for establishing, understanding, and implementing the scope of reasonably available alternatives when making a recommendation).

- The factors the broker-dealer considers to assess the potential risks, rewards, and costs of the recommendations in light of the retail customer's investment profile.
- The broker-dealer's process for having a reasonable basis to believe that it does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer.
- How the broker-dealer makes recommendations related to significant investment decisions, such as rollovers and account recommendations, and how the broker-dealer has a reasonable basis to believe that such investment strategies are in a retail customer's best interest.
- How the broker-dealer makes recommendations related to more complex, risky or expensive products and how the broker-dealer has a reasonable basis to believe that such investments are in a retail customer's best interest.
- **Conflict of Interest Obligation.** The Conflict of Interest Obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest associated with its recommendations to retail customers.<sup>11</sup>

Document Requests. To assess compliance with this obligation, staff may review the broker-dealer's policies and procedures to assess:

- Whether and how the policies and procedures address the following, as required by Regulation Best Interest:
  - conflicts that create an incentive for an associated person to place its interest or the interest of a broker-dealer ahead of the interest of the retail customer;
  - conflicts associated with material limitations (*e.g.*, a limited product menu, offering only proprietary products, or products with third-party arrangements) on the securities or investment strategies involving securities that may be recommended to a retail customer; and
  - the elimination of the following conflicts: sales contests, sales quotas, bonuses, and non-cash compensation based on the sale of specific securities or specific types of securities within a limited period of time.

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<sup>11</sup> Exchange Act Rule 15l-1(a)(2)(iii) ("The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to: (A) Identify and at a minimum disclose, in accordance with paragraph (a)(2)(i) of this section, or eliminate, all conflicts of interest associated with such recommendations; (B) Identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for a natural person who is an associated person of a broker or dealer to place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; (C)(1) Identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, in accordance with subparagraph (a)(2)(i), and (2) Prevent such limitations and associated conflicts of interest from causing the broker, dealer, or a natural person who is an associated person of the broker or dealer to make recommendations that place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and (D) Identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.").

- How the policies and procedures establish a structure for identifying the conflicts that the broker-dealer or its associated person may face. Staff may request documentation identifying all conflicts associated with the broker-dealer's recommendations.
- How the policies and procedures establish a structure to identify and assess conflicts in the broker-dealer's business as it evolves. Staff may request to see all policies and procedures in place during the scope period of the examination.
- How the policies and procedures provide for disclosure of conflicts and what conflicts are disclosed.
- How the policies and procedures provide for mitigation or elimination of conflicts and what conflicts are mitigated or eliminated.<sup>12</sup>
- **Compliance Obligation.** The Compliance Obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest as a whole.<sup>13</sup>

Document Requests. To assess compliance with this obligation, staff may review the broker-dealer's policies and procedures and evaluate any controls, remediation of noncompliance, training, and periodic review and testing included as part of those policies and procedures.

While these are the primary focus areas for the initial Regulation Best Interest examinations, staff may select additional areas for review based on risks identified during the course of the examinations. As part of OCIE's efforts to promote compliance, OCIE is including, as an Appendix to this Risk Alert, a sample request for information and documents to be reviewed during these examinations.

### III. Conclusion

In sharing the focus for these initial examinations, OCIE encourages firms to assess their implementation plans for Regulation Best Interest. Not every document listed in this Risk Alert will be applicable to every firm, and OCIE will conduct examinations based on the profile of each broker-dealer. OCIE is providing transparency into its plans regarding Regulation Best Interest examinations to empower broker-dealers to assess their level of preparedness as the compliance date nears.

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<sup>12</sup> Under Regulation Best Interest, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to mitigate or eliminate certain conflicts of interest. Conflicts related to incentives to associated persons must be identified and mitigated. Exchange Act Rule 15l-1(a)(2)(iii)(B). Conflicts related to any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time must be identified and eliminated. Exchange Act Rule 15l-1(a)(2)(iii)(D).

<sup>13</sup> Exchange Act Rule 15l-1(a)(2)(iv) ("In addition to the policies and procedures required by paragraph (a)(2)(iii) of this section, the broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.").

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*This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.*

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## APPENDIX

This document provides a sample list of information that the U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") may request when conducting examinations of broker-dealers regarding Regulation Best Interest. OCIE has published this document as a resource for broker-dealers. This document should not be considered all-inclusive of the information that OCIE may request or the validation and testing OCIE may perform of firm policies and procedures. Accordingly, OCIE will alter its requests for information as it considers the specific circumstances presented by each firm's business model. OCIE understands that not every document listed below will be applicable to every firm.

The following document requests apply to a broker-dealer's ("Registrant's") business units that may open accounts for and/or make recommendations to natural persons or their legal, non-professional representatives, including high net worth individuals, primarily for personal, family, or household purposes ("retail customers"). For purposes of this request, "Relationship Summary" refers to the document completed pursuant to Form CRS. In addition, broker-dealers should be aware that the "Scope Period" will differ for each examination and may include a time period prior to the compliance date.

- A. General Information. To the extent applicable, provide the following information as of the date of this request and identify any changes made over the Scope Period (*e.g.*, under item 1, any account types introduced; and under item 6, any products that have been removed from the list).
1. Description of available brokerage account types that a retail customer may establish, including any limitations on the types of retail customers that may establish such account types (*e.g.*, high net worth only or based on minimum account values), the basic features of such account types, and any services or products (including account monitoring) associated with such account types.
  2. Description of any non-brokerage accounts, including advisory accounts, that a prospective customer who is a retail customer may establish through an associated person of the Registrant, even if the account will be held outside of the Registrant.
  3. Copy of any schedule of fees and charges that may be assessed for retail customers.
  4. Copy of any grid or schedule given to registered personnel that sets forth a compensation method, which may be limited to registered personnel who provide services or recommendations to retail customers.
  5. If not covered by the prior item, description of the compensation method used for registered personnel that may be paid by any third party. Include any additional compensation that may be paid for certain types of products or accounts, or based on certain earning levels.
  6. A list of any proprietary products sold to retail customers.
  7. A list of any third parties or affiliates with which the Registrant has arrangements for sale of their products to retail customers.

8. If the Registrant subjects any products or account types to a focused review to determine consistency with Regulation Best Interest or to consider potential modifications or limitations for consistency with Regulation Best Interest, a list of those products or account types.
  9. If not covered by the items above, a list of any other products offered by the Registrant for sale to retail customers.
  10. Copies of marketing materials given to retail customers, including any that use the term “adviser” or “advisor.”
  11. Documentation that identifies and analyzes all conflicts of interest associated with recommendations to retail customers.
- B. Copies of all written policies, procedures, memoranda, or other materials (including changes made over the Scope Period) on which the Registrant relies for compliance with respect to Regulation Best Interest, which may include, for example, documents that:
1. Include the process, as applicable, to (a) identify and disclose; (b) identify and mitigate; and (c) identify and eliminate any conflicts of interest related to recommendations to retail customers.
  2. Include the process to create, update, file, and deliver the Relationship Summary and other disclosures to be made to retail customers under Regulation Best Interest.
  3. Include the process to make and document oral disclosures.
  4. Include the process to obtain and update customer investment profiles.
  5. Include the process to understand the risks, rewards, and costs associated with products offered to retail customers.
  6. Include the process for identifying implicit hold recommendations.
  7. Include the process for how the Registrant determines that it has a reasonable basis to believe that a recommendation is in the best interest of the retail customer.
  8. Provide to registered personnel of the Registrant any considerations and limitations on making recommendations to retail customers (including when recommendations must be documented) and the disclosures that must be made to retail customers.
  9. Provide any supervisory or compliance reviews or authorizations prior to recommending any account or product, including any rollovers from other accounts.
  10. Include the process to monitor or surveil trading or account establishment for compliance with Regulation Best Interest.
- C. Copy of the Relationship Summary provided to retail customers and all other documents provided to retail customers for the purpose of meeting the Disclosure Obligation under



Regulation Best Interest. If different documents are used for different types of retail customers (*e.g.*, based on business segment or account type), identify which documents would be given to each type of retail customer.

- D. Copies of any training materials used to train employees on Regulation Best Interest.
- E. Copies of any surveillance and monitoring reports designed to identify recommendations inconsistent with Regulation Best Interest, which may include any analysis of account type recommendations, rollovers, high account turnover, complex products, and high risk products.
- F. For the Scope Period, provide:
  - 1. A list of all new accounts established on behalf of individual customers (including new accounts established for existing customers), which may include some or all of the following: account identifying information; the date the account was opened; the date the Relationship Summary was delivered; the date any other documents were delivered for purposes of Regulation Best Interest and the type of document delivered; the type of account established; whether the account type was recommended; the registered person assigned to the account; and whether the assets in the account were transferred from another account at the Registrant or from a retirement account outside of the Registrant, and, if so, the type of account from which the assets were transferred.
  - 2. A blotter containing all trading conducted on behalf of individual customers, which may include some or all of the following: the trade date; whether the trade was a purchase or sale; the security name; the CUSIP; the share quantity; the share price; account identifying information; the account type; whether the trade was solicited or unsolicited; and the name and CRD number of the registered person assigned to the account.
  - 3. A list of retail customers for which a customer investment profile was created or updated, which may include some or all of the following: the date the information was received, account identifying information, and the types of accounts held at Registrant.