

# FULL SPEED AHEAD ON REGULATION BEST INTEREST AND FORM CRS

## JUNE 30 IMPLEMENTATION DEADLINES & FINRA PROPOSES RULE CHANGES TO ALIGN WITH REGULATION BEST INTEREST

Date: 14 April 2020

### Investment Management Alert

### INTRODUCTION

On April 2, 2020, U.S. Securities and Exchange (“SEC”) Chairman Jay Clayton announced that the original June 30 compliance deadlines for Form CRS and Regulation Best Interest (“Reg BI”) will remain in effect, notwithstanding the potential adverse and disruptive effects of the spread of COVID-19 on the businesses of investment advisers and broker-dealers. Chairman Clayton encouraged firms to coordinate with SEC staff in the event that they are unable to comply with any requirements due to firm-specific circumstances, but explained that the SEC saw no reason why these new investor protection measures should be delayed.

In addition, on March 12, 2020, the Financial Industry Regulatory Authority, Inc. (“FINRA”) proposed amendments to its rules to exempt certain types of recommendations subject to Reg BI from the FINRA suitability rules.<sup>1</sup> Reg BI was adopted on June 5, 2019, to replace the broker-dealer suitability standard of care that has historically applied when a broker-dealer recommends a securities transaction to a natural-person customer. The proposed rule amendments would:

- Amend the FINRA and Capital Acquisition Broker (“CAB”) suitability rules<sup>2</sup> to state that the rules do not apply to recommendations subject to Reg BI;
- Extend quantitative suitability obligations to cover cases where a broker-dealer does not have “control” over a customer account; and
- Conform the rules<sup>3</sup> governing noncash compensation to Reg BI’s limitations on sales contests, sales quotas, bonuses, and noncash compensation.

FINRA has submitted these proposed amendments to the SEC. If approved, the effective date of the amendments will be the same as the compliance date of Reg BI, June 30, 2020.

### RULE 2111 WOULD NOT APPLY TO RECOMMENDATIONS SUBJECT TO REG BI

In its proposal filed with the SEC, FINRA noted that Reg BI addresses the same conduct that is addressed by Rule 2111 (Suitability) but employs a best-interest standard rather than a suitability standard. FINRA reasoned that if it did not revise its rules, a broker-dealer would be required to comply with both Reg BI and Rule 2111 regarding recommendations to retail customers.<sup>4</sup> Compliance with Reg BI would result in compliance with Rule

2111 because a broker-dealer that meets the best interest standard necessarily meets the suitability standard, according to FINRA. Therefore, FINRA is proposing to limit the application of Rule 2111 to circumstances in which Reg BI does not apply.

FINRA Rule 2111(b) provides for a more permissive suitability standard for a broker-dealer making a recommendation to an “institutional account,” as defined in Rule 4512(c). While the industry speculated that FINRA might revise the definition of “institutional account” in Rule 4512(c) to align with the definition of “retail customer” by excluding natural persons, FINRA did not take that approach. Rather, Rule 4512(c) will remain unchanged and will continue to include the account of:

- a bank, savings and loan association, insurance company, or registered investment company;
- an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or
- any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least US\$50 million.

In retaining natural persons in the definition of institutional account, FINRA correctly anticipates scenarios where a natural person may be investing for reasons other than personal, family, or household purposes, such as in the cases of investing for small-business and charitable trusts. Accordingly, firms will be required to determine whether Reg BI or Rule 2111 applies in the context of their particular businesses and client base.

## **ELIMINATION OF CONTROL ELEMENT IN QUANTITATIVE SUITABILITY OBLIGATION**

In addition, FINRA's proposed amendments would modify the quantitative suitability obligation under FINRA Rule 2111, Supplementary Material .05(c), to remove the element of control that currently must be proved to demonstrate a violation. Rule 2111 imposes three main suitability obligations: (1) reasonable basis suitability, (2) customer-specific suitability, and (3) quantitative suitability.<sup>5</sup> Fulfillment of the quantitative suitability obligation currently requires a FINRA 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. The proposed change is consistent with Reg BI, which applies to any series of transactions recommended to a retail customer, regardless of whether the broker-dealer or an associated person has control over the customer's account.

## **NONCASH COMPENSATION RULES CONFORMED TO REG BI'S LIMITATIONS ON SALES CONTESTS, SALES QUOTAS, BONUSES, AND NONCASH COMPENSATION**

Existing FINRA rules related to certain products, such as direct participation programs, variable contracts of an insurance company, investment company securities, and underwritten offerings, restrict the payment and receipt of noncash compensation in connection with the sale and distribution of those products. Those rules generally limit noncash compensation to:

- Gifts that do not exceed US\$100 in value and that are not preconditioned on the achievement of a sales target;<sup>6</sup>
- An occasional meal, a ticket to a sporting event or the theater, or other comparable entertainment that does not raise any question of propriety and is not preconditioned on the achievement of a sales target;
- Payment or receipt by “offerors” (generally product sponsors and their affiliates) in connection with training or education meetings, subject to specified conditions, including that the payment of such compensation is not conditioned on achieving a sales target; and
- Internal noncash compensation arrangements between a member and its associated persons, subject to specified conditions. If the internal noncash compensation arrangement is in the form of a sales contest, the contest must be based on the total production of associated persons with respect to all securities within the rule's product category and credit for those sales must be equally weighted.

Reg BI's provisions regarding conflicts of interest require broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and eliminate any sales contests, sales quotas, bonuses, and noncash compensation that are based on the sales of specific securities or specific types of securities within a limited period. FINRA's current noncash compensation rules permit internal firm sales contests that may not meet this standard, since they permit contests based on sales of specific types of securities (such as mutual funds or variable annuities). FINRA has proposed to amend its rules governing noncash compensation arrangements to specify that any noncash compensation arrangement permitted by those rules must be consistent with the requirements of Reg BI. Consistent with this change, FINRA has also proposed to eliminate provisions in Rules 2320 and 2341 for variable contracts and investment company shares that reference internal noncash compensation arrangements based on total production and equal weighting of securities sales.

If FINRA's proposals are enacted, broker-dealers would no longer be permitted to sponsor or maintain internal sales contests based on sales of securities within a product category within a limited time, even if they are based on total production and equal weighting. Other noncash compensation, such as gifts, business entertainment, and training or education meetings, would also not be allowed to be preconditioned on an achievement of a sales target.

## **REG BI DOES APPLY TO CABS**

CABs are FINRA member broker-dealers that engage in a limited range of activities, including advising companies and private equity funds on capital raising and corporate restructuring and acting as placement agents for sales of unregistered securities to institutional investors under limited conditions. CABs are not permitted, among other things, to carry or maintain customer accounts, handle customer funds or securities, accept customers' trading orders, or engage in proprietary trading or market making. The proposed rule change would amend the suitability standard for CABs, contained in CAB Rule 211, to state that the CAB suitability rule will not apply to recommendations subject to Reg BI. Accordingly, if a CAB is making a recommendation to a customer who would be an institutional account as defined in FINRA Rule 4512(c), but is a natural person investing for personal, family, or household purposes, then Reg BI would apply.

## **LOOKING AHEAD**

As noted above, on April 2, 2020, Chairman Clayton confirmed that the “June 30, 2020 compliance date for Reg BI and other requirements, including the requirement to file and begin delivering Form CRS, remains appropriate.” Although the SEC has granted various forms of relief to market participants due to the impact of COVID-19, the Reg BI and Form CRS deadline remains in effect. Chairman Clayton pointed out that “[a]t any time, and particularly in times of uncertainty, investment professionals should not put their interests ahead of the interests of their clients and customers.” In fact, on April 7, the SEC’s Office of Compliance Inspections and Examinations published two Risk Alerts to provide firms with information about the scope and content of upcoming initial examinations for compliance with Reg BI and Form CRS.<sup>7</sup>

These statements, along with FINRA’s proposed rule changes, should serve as a reminder to market participants that FINRA and the SEC will implement Reg BI according to schedule. Reg BI is also the subject of pending litigation in the federal courts.<sup>8</sup> Nevertheless, market participants should take note of these events and plan to be Reg BI-compliant by June 30, 2020. The broker-dealer team at K&L Gates looks forward to assisting market participants navigate these developments, and recent and proposed changes by the SEC and FINRA with respect to Reg BI.<sup>9</sup>

## Practical Implications

- Market participants should plan to implement Reg BI by the end of the second quarter. These proposed amendments are the most recent indication that Reg BI is expected to be implemented, as FINRA amends its rules to conform with Reg BI.
- Firms should allow advance time to ensure that mailings of Form CRS and any related disclosures are complete by the June 30 deadline.
- The proposed rule should reduce the potential for confusion because, if implemented, market participants would know that a recommendation to a retail customer would come under the ambit of Reg BI rather than being subject to both Reg BI and FINRA suitability considerations.
- Any market participant facing difficulties in implementing Reg BI or Form CRS due to the effects of COVID-19 should communicate its particular circumstances to the SEC.

## FOOTNOTES

<sup>1</sup> FINRA, [Proposed Rule Change to FINRA’s Suitability, Non-Cash Compensation and Capital Acquisition Broker \(CAB\) Rules in Response to Regulation Best Interest](#), (Mar. 12, 2020).

<sup>2</sup> FINRA proposed amendments to Rules 2111 (Suitability), 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company), 2341 (Investment Company Securities), and 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements), and Capital Acquisition Broker (CAB) Rule 211 (Suitability).

<sup>3</sup> The following rules would be amended: FINRA Rules 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company), 2341 (Investment Company Securities), and 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements). Each of these rules include provisions restricting the payment and receipt of noncash compensation in connection with the sale and distribution of securities.

<sup>4</sup> A “retail customer” for Reg BI purposes is a natural person, or the legal representative of such natural person,

who (a) receives a recommendation of any securities transaction or 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. A “legal representative” of such person includes a nonprofessional legal representative, such as a nonprofessional trustee that represents the assets of a natural person.

<sup>5</sup> Reasonable basis suitability requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. Customer-specific suitability 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.

<sup>6</sup> A 2016 proposal to increase these limitations was considered but never acted upon. FINRA Regulatory Notice 16-29, *Gifts, Gratuities and Non-Cash Compensation Rules* (Aug. 2016).

<sup>7</sup> An upcoming K&L Gates Alert will describe the implications of these Risk Alerts for broker-dealers and investment advisers.

<sup>8</sup> See *State of New York v. SEC*, No. 19-2893 (2d Cir. 2019).

<sup>9</sup> Please see the K&L Gates HUB webpage on Regulation Best Interest, which has many useful resources for market participants seeking information on Regulation Best Interest, [here](#) and [here](#).

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