

# TRIGGERING REGULATION BEST INTEREST: WHAT ARE “RETAIL CUSTOMERS” AND “RECOMMENDATIONS”

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## U.S. Investment Management Alert

By: Richard F. Kerr, Pablo J. Man, Eden L. Rohrer, C. D. Peterson, Andrew J. Shipe

On June 5, 2019 the Securities and Exchange Commission ("SEC" or the "Commission") adopted Regulation Best Interest to require broker-dealers to observe a new standard of conduct when recommending securities or investment strategies to retail customers. A more detailed discussion of Regulation Best Interest, "SEC Adopts A New Best Interest Standard of Conduct" can be found [here](#).

At the time the Commission voted to adopt Regulation Best Interest, it also voted on other related initiatives:

- New Form CRS; and
- Interpretations regarding an investment adviser's fiduciary duty and the "solely incidental" factor of the broker-dealer exclusion from the definition of an "investment adviser" under the Investment Advisers Act of 1940 ("Advisers Act").

Each of these related rules and interpretations will be the subject of separate *Alerts* issued by our firm. Please visit the [K&L Gates HUB](#) to access these *Alerts* when available.

In short, Regulation Best Interest applies to all broker-dealers who make "recommendations" to "retail customers." Each of these factors is key to applying Regulation Best Interest, as discussed in greater detail below. **All broker-dealers, however, (regardless of whether they have retail customers) must consider whether and how these measures impact their regulatory obligations.**

## I. WHO IS A RETAIL CUSTOMER?

All broker-dealers must consider whether they have "retail customers" as that term is defined in Regulation Best Interest. For these purposes, a "retail customer" is defined as a natural person, or the legal representative of such natural person, who:

- 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
- uses the recommendation primarily for personal, family, or household purposes. [1]

The definition contains two essential parts -- (1) whether there was a recommendation and (2) whether the recommendation was used primarily for personal, family, or household purposes.

### A. High Net-Worth Natural Persons

Regulation Best Interest does not exclude high net-worth individuals from treatment as "retail customers." Thus, Regulation Best Interest contrasts from other regulations that allow more flexibility for dealings with individual investors who meet certain minimum standards of net worth, and who are presumed to have the sophistication and wherewithal to understand and withstand investment risk. Regulation Best Interest does not treat certain high net-worth individuals as institutional investors as is the case under suitability and advertising rules established by the Financial Industry Regulators Authority ("FINRA"). FINRA Rule 4512(c)(3) defines the term "institutional account" to include natural persons with assets of at least \$50 million. A high net-worth individual's treatment as "institutional" excludes their account from, among other things, FINRA's "customer-specific" suitability review requirements.

The Commission stated that it decided not to align Regulation Best Interest with FINRA's treatment of "institutional" high net-worth natural persons because "conflicted recommendations can also result in harm to high net-worth individuals" and net worth "may not necessarily correlate to a particular level of financial sophistication," citing several enforcement cases related to schemes to defraud professional athletes. [2] Accordingly, institutional broker-dealers who maintain accounts for high net-worth individuals, which they may treat as institutional for FINRA purposes, should review those accounts to determine if they receive recommendations and if those recommendations could be used primarily for personal, family, or household purposes. If the definition covers those accounts, the firm must comply with Regulation Best Interest and must file and distribute Form CRS.

## B. Legal Representatives of Natural Persons

The definition of "retail customer" also extends to "legal representatives" of natural persons. The Commission clarified that it views legal representatives of a natural person to cover only **non-professional legal representatives**, such as a non-professional trustee that represents the assets of a natural person or similar representatives, such as executors, conservators, and persons holding a power of attorney for a natural person. The SEC did not provide additional commentary if this class of representatives also would include attorneys or accountants. The SEC did specify that non-professional legal representatives would not include regulated financial industry professionals such as employees of banks, trust companies, insurance companies, registered investment advisers, [3] or other similar financial institutions. A determination of status as a "non-professional legal representative" will have important implications for representatives that represent family trusts, family offices, and representatives in the retirement plan context, noted below.

## C. Trusts and Family Offices

Absent more precise guidance from the Commission or its staff, the definition of "retail customer" could nonetheless extend to certain trusts or family offices, if they are acting on behalf of one or more natural persons and investments are not primarily for commercial or business purposes. Inasmuch as the SEC does not consider "regulated financial industry professionals" to be covered by the definition of "retail customer," even when acting on behalf of a natural person, a representative acting for a family trust or family office that is not "regulated" would by extension be a "legal representative" of a natural person and retail customer for investments that are for personal, family, or household purposes.

When the SEC first proposed Regulation Best Interest, the definition of a "retail customer" included "any person" and was not limited to "natural persons," with the express intent to cover family trusts that received recommendations for personal, family, or household use. The SEC noted that the final definition still covers family

trusts to the extent that a trustee is a "non-professional" trustee and not otherwise a regulated corporate fiduciary, such as a bank, trust company, or registered investment adviser or their employees.

The nexus to a regulated financial intermediary, however, seems to capture others that might not have obvious attributes of a retail customer. For instance, family offices that satisfy conditions prescribed by the Advisers Act are not considered to be investment advisers by definition, not typically registered as investment advisers, and could be covered by the retail customer definition as a "legal representative" of a natural person if recommendations were used for family purposes. On the other hand, family offices that have registered as investment advisers presumably would not be a "legal representative" of a natural person because, in that particular instance, the family office would be a regulated financial intermediary, and outside of the retail customer definition.

Thus, a broker-dealer that recommends transactions to a non-professional trustee or to a family office (that is not otherwise registered as an investment adviser) would need to consider if these accounts are retail and subject to Regulation Best Interest.

## **D. Personal, Family, or Household Purposes**

### ***1. Commercial and Business Purposes***

The definition of "retail customer" is qualified by the requirement that the recommendation must be used "primarily for personal, family or household purposes." The definition would not apply to natural persons seeking services for commercial or business purposes. Accordingly, this would not include an employee seeking services for an employer or an individual who is seeking services for a small business or on behalf of, for example, a charitable trust. Because this qualifier is vague, particularly the meaning of "primarily," we expect that the industry will seek greater clarity from the SEC staff as to scope and meaning in particular circumstances.

### ***2. Retirement and Other Tax-Advantaged Savings Purposes***

The Commission was more precise in the context of retirement and other forms of personal savings, such as savings accounts for college. For instance, the Commission clarified that retirement saving is considered a "personal, family or household" purpose, which means that recommendations used for investments in a person's individual retirement account ("IRA") or participant-directed retirement plan would constitute a recommendation to a retail customer. Similarly, saving for college via a college tuition savings plan qualified pursuant to Section 529 of the Internal Revenue Code ("529 Plan") would be for a personal, family, or household purpose because broker-dealers may be 529 Plan providers that recommend use of underlying investment options to retail customers for tax-favored savings for college. The Commission identified other types of tax-favored plans, such as Health Savings Accounts and Coverdale accounts as also having a personal, family, and household use.

In these contexts, it is important to distinguish recommendations in the retirement or 529 Plan context from information conveyed solely for purposes of informing the participants about the workings of the plan. Broker-dealers often offer plan education to retirement plan participants as part of their enrollment in a retirement plan. Educational efforts have not traditionally risen to a recommendation because of the general nature of the communications. Plan education combined with a recommendation, such as a recommendation to take a distribution from a plan, would be covered by Regulation Best Interest.

Recommendations in connection with a defined benefit plan presumably would not be included because those types of plans are not participant directed, and the person receiving those recommendations are, first, not using

the recommendations for their own accounts and, second, should not be deemed to be doing so as a "legal representative" of a natural person. In the defined benefit plan context, it is difficult to discern how a plan sponsor, such as an employer, could act as a legal representative of a natural person who otherwise has no influence on plan investment. Equally difficult, it is not clear how a broker-dealer could make a best interest assessment when the firm has no ability to obtain a customer investment profile and, in any event, investments are for the defined benefit plan as a whole. The Commission may need to further clarify recommendations in the defined benefit plan context because its analysis spoke in terms of "workplace retirement plans," without making careful distinctions between defined benefit and defined contribution plans, each of which are very different and have accepted meanings in the industry.

The Commission or its staff also may need to clarify whether Regulation Best Interest applies to interactions with defined benefit and defined contribution plans, as to the plan sponsor or other plan administrator, in connection with the construction of the plan or, in the case of a defined contribution plan, the creation of the menu of investment options for direction by individual plan participants. It would appear that in these settings, Regulation Best Interest should not apply, because at these stages of constructing the plan, there is no use of the investment options by any natural person. Again, the Commission's use of the term "workplace retirement plan" in this context is confusing because that term has no accepted understanding when applied to defined benefit and defined contribution plans.

The SEC, however, concluded that a retirement plan for a sole proprietor or "self-employed" individual with "one or more" employees would be a "retail customer." Thus, the SEC effectively looks through the plan structure because the sole proprietor and self-employed individual participates in the plan as distinguished from large corporate-sponsored defined benefit and defined contribution plans.

## II. WHAT IS A RECOMMENDATION?

### A. PRINCIPLES FROM FINRA'S SUITABILITY RULE

Key to the application of Regulation Best Interest and also contained in the definition of "retail customer" is the term "recommendation." In proposing and adopting Regulation Best Interest, the SEC specifically declined to define the term "recommendation," instead deferring to longstanding FINRA guidance and case law, which it reasoned works well for these purposes and is familiar to broker-dealers. The SEC explained that what constitutes a recommendation is highly fact specific and not conducive to an express definition in the rule text. According to the SEC, factors to consider include whether a 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." Thus, the more tailored a communication is to a specific customer or group of investors, the more likely it is a recommendation.

FINRA has also historically declined to define the term "recommendation," but has interpreted it from time to time, including in Regulatory Notice 11-02, published in January 2011, where it identified several guiding principles relevant to determining whether a communication could be viewed as a recommendation for purposes of its suitability rule. FINRA explained:

... a communication's content, context and presentation are important aspects of the inquiry. The

determination of whether a “recommendation” has been made, moreover, is an objective rather than subjective inquiry. An important factor in this regard is whether—given its content, context and manner of presentation—a particular communication from a firm or associated person to a customer reasonably would be viewed as a suggestion that the customer take action or refrain from taking action regarding a security or investment strategy. In addition, the more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a recommendation. Furthermore, a series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program. [4]

## **B. Communications That Are Not A Recommendation**

### ***1. General Financial and Investment Information***

According to the SEC, a communication that conveys general financial and investment information would not be a recommendation. This includes communications about (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) assessment of a customer's investment profile.

These types of communications tend to fall in the category of "educational" and are not specific enough to constitute a "call to action" or a focused communication that targets a particular investor or investor group or otherwise matches an investment with an investor's investment profile. As a result, these communications are too general to be considered a recommendation.

### ***2. Educational Materials for Retirement***

Communications generally about retirement plan investing and how it works are not specific enough to be recommendations. Thus, descriptive information about an employer-sponsored retirement plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan have traditionally been considered educational.

### ***3. Asset Allocation Modeling***

Certain asset allocation modeling is not considered to be a recommendation, according to the SEC, although it could be investment advice for which the broker-dealer exclusion from the Advisers Act would be necessary. Models (and any interactive investment materials that incorporate the models) that would not be considered recommendations are models:

- based on generally accepted investment theory;
- 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
- in compliance with FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by FINRA Rule 2214.



## C. Communications That Are Recommendations

### 1. Purchase, Sales and Exchanges

The SEC clarified that a recommendation applies to "any securities transaction" (which includes a purchase, sale or exchange).

### 2. Explicit and Implicit Hold Recommendations

A communication to a retail customer explicitly to hold a security is a recommendation subject to Regulation Best Interest. Although Regulation Best Interest does not impose a duty to monitor retail customer brokerage accounts, a firm formally and contractually (as opposed to voluntarily) can create cases in which recommendations are explicit (purchase, sell, exchange, or hold) and implicit. According to the Commission, an implicit recommendation could apply if a broker-dealer undertakes to perform account monitoring services by contract and has agreed to periodic reviews, the firm is subject to a best interest standard of care if it provides no direction as to the holdings and rather implicitly recommends maintaining the *status quo*. In this case, the firm is "recommending" an investment strategy of the *status quo* and would need a reasonable basis to believe the strategy was in the best interests of the retail customer based on the customer's investment profile.

### 3. Retirement Investing Recommendations

In contrast to educational communications, the SEC stated that communications in the retirement plan context that recommend specific investments or distributions from specific securities would be recommendations to retail customers subject to Regulation Best Interest.

### 4. Account Types Involving A Recommendation

The text of Regulation Best Interest clarifies it applies to "account recommendations." The SEC explained that this includes recommendations of securities account types generally, as well as recommendations to roll over or transfer assets from one type of account to another (e.g., workplace retirement plan to an IRA). The standard applies even if there is not a recommendation of a specific securities transaction and regardless of whether the account recommendation is connected with a specific securities transaction. In addition to traditional brokerage and investment advisory accounts, the SEC provided numerous examples of account types that a broker-dealer might recommend and thereby trigger Regulation Best Interest, including education accounts (e.g., 529 Plans and tax-free Coverdell accounts); retirement accounts (e.g., IRA, Roth IRA, or SEP-IRA accounts); and specialty accounts (e.g., cash or margin accounts, and accounts with access to Forex or options trading). The SEC noted that recommendations for accounts with different levels of services, such as access to online trading, or access to products with break-points, may also implicate Regulation Best Interest.

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## NOTES

[1] 17 CFR §240.15l-1(b)(1).

[2] *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Securities Exchange Act Release No. 86031, at 113 n. 239 (Jun. 5, 2019).

[3] The SEC did not distinguish between SEC-registered and state-registered investment advisers.

[4] See <https://www.finra.org/sites/default/files/NoticeDocument/p122778.pdf> (footnotes omitted).

## KEY CONTACTS



**RICHARD F. KERR**

PARTNER

BOSTON

+1.617.261.3166

RICHARD.F.KERR@KLGATES.COM



**PABLO J. MAN**

PARTNER

BOSTON

+1.617.951.9209

PABLO.MAN@KLGATES.COM



**EDEN L. ROHRER**

PARTNER

NEW YORK

+1.212.536.4022

EDEN.ROHRER@KLGATES.COM

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