

# Components of Regulation Best Interest<sup>1</sup>

PURPOSE/INTENT	REQUIREMENT	REQUIREMENT	EXAMPLES
<p><b>1 DISCLOSURE OBLIGATION</b></p>	<p>To facilitate the retail customer's awareness of certain key information regarding their relationship with the broker-dealer by requiring more explicit disclosure obligations on broker-dealers.</p>	<p>Requires a broker-dealer or "<b>natural person who is an associated person</b>" of a broker-dealer to, "<b>prior to or at the time</b>" a "<b>recommendation</b>" of any securities transaction or investment strategy involving securities to a "<b>retail customer</b>" is made, reasonably disclose to the retail customer, in writing, the <u>material facts</u> relating to the scope and terms of the relationship with the retail customer and all <u>material conflicts of interest</u> associated with the recommendation.</p> <p><u>Form of disclosure</u>: disclosure should be clear and concise, applying plain English principles, using short sentences and active voice, and avoiding legal jargon, technical terms and multiple negatives.</p>	<p>Examples of <u>material facts</u> relating to the scope and terms of the relationship with the retail customer:</p> <p>(i) that the broker-dealer is acting in a <u>broker-dealer capacity</u> with respect to the recommendation;</p> <p>(ii) <u>fees and charges</u> that apply to the retail customer's transactions, holdings and accounts; and</p> <p>(iii) <u>type and scope of services</u> provided by the broker-dealer, including, for example, monitoring the performance of the retail customer's account.</p> <p>Examples of <u>material conflicts of interest</u> associated with a recommendation include conflicts arising from financial incentives such as recommending:</p> <ul style="list-style-type: none"> <li>• proprietary products;</li> <li>• products of affiliates or a limited range of products;</li> <li>• a specific share class of a mutual fund;</li> <li>• securities underwritten by the broker-dealer's firm or its affiliate;</li> <li>• the rollover or transfer of assets from one type of account to another; and</li> <li>• allocation of investment opportunities among retail customers (e.g., IPO allocation).</li> </ul>
<p><b>2 CARE OBLIGATION</b></p>	<p>To incorporate and enhance existing suitability requirements applicable to broker-dealers under the federal securities laws by, among other things, imposing a "best interest" requirement that requires the broker-dealer not put its own interest ahead of the retail customer's interest when making recommendations.</p>	<p>Requires 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:</p> <p>(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 (i.e., <u>reasonable-basis suitability</u>);</p> <p>(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 (i.e., <u>customer-specific suitability</u>); and</p> <p>(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 (i.e., <u>quantitative suitability</u>).</p> <p>The Care Obligation cannot be satisfied through disclosure alone.</p>	<p>Example factors for assessing <u>reasonable-basis suitability</u> of a security or investment strategy include evaluating the associated costs, investment objectives, characteristics (including any special or unusual features), liquidity, 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.</p> <p>Example factors for assessing <u>customer-specific suitability</u> include 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.</p> <p>Example factors for assessing <u>quantitative suitability</u> by providing a basis for determining that a series of recommended transactions may be excessive include turnover rate, cost-to equity ratio, use of in-and-out trading in a customer's account and any other factors that can be indicative of the magnitude of investor harm caused by the accumulation of high trading costs.</p>
<p><b>3 CONFLICT OF INTEREST OBLIGATIONS</b></p>	<p>To enhance the disclosure of material conflicts of interest in order to educate retail customers about such conflicts and help them evaluate recommendations received from broker-dealers, and to establish obligations on broker-dealers to not just disclose, but also mitigate, conflicts of interest arising from financial incentives associated with their recommendations.</p>	<p>Requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to:</p> <p>(1) identify and disclose, or eliminate, all "<b>material conflicts of interest</b>" that are associated with its recommendations to retail investors; and</p> <p>(2) identify, and disclose and mitigate, or eliminate, "<b>material conflicts of interest arising from financial incentives</b>" associated with such recommendations.</p> <p>Broker-dealers cannot comply with the Conflict of Interest Obligations of Regulation Best Interest by simply creating policies and procedures. The policies and procedures must also be effectively maintained and enforced.</p>	<p>There is no one-size-fits-all approach; reasonably designed policies and procedures should be tailored to account for the business practices, size and complexity of the broker-dealer, range of services and products offered and associated conflicts presented.</p> <p>The SEC has stated that it would be reasonable for broker-dealers to use a risk-based compliance and supervisory system to promote compliance (rather than conducting a detailed review of each recommendation).</p> <p>Among the components that broker-dealers should consider including in their programs are:</p> <ul style="list-style-type: none"> <li>• policies and procedures outlining how the firm identifies its material conflicts (and material conflicts arising from financial incentives) and specifying how the broker-dealer intends to address each conflict;</li> <li>• robust compliance review and monitoring systems;</li> <li>• processes to escalate identified instances of noncompliance to appropriate personnel for remediation;</li> <li>• procedures that clearly designate responsibility for supervision of functions and persons, including determination of compensation;</li> <li>• processes for escalating conflicts of interest;</li> <li>• processes for a periodic review and testing of the adequacy and effectiveness of policies and procedures; and</li> <li>• training on the policies and procedures.</li> </ul>

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## KEY DEFINITIONS (IN ALPHABETICAL ORDER)

TERM	DEFINITION
1 MATERIAL CONFLICTS ARISING FROM FINANCIAL INCENTIVES	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.
2 MATERIAL CONFLICTS OF INTEREST	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.
3 NATURAL PERSON WHO IS AN ASSOCIATED PERSON OF A BROKER-DEALER	A natural person who is an associated person as defined under Section 3(a)(18) of the Securities Exchange Act of 1934: "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)."
4 PRIOR TO OR AT THE TIME A RECOMMENDATION IS MADE	The Disclosure Obligation of Regulation Best Interest would apply when a broker-dealer is making a recommendation about any securities transaction or investment strategy to a retail customer. 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.
5 RECOMMENDATION	<p>The SEC proposes to apply Regulation Best Interest to recommendations of any securities transaction (sale, purchase, and exchange) 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. Securities transactions may also include recommendations to roll over or transfer assets from one type of account to another.</p> <p>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." The more individually tailored the communication to a specific customer or targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a "recommendation."</p>
6 RETAIL CUSTOMER	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>1</sup>The SEC's proposed Regulation Best Interest is available at <https://goo.gl/iqm2EC>.