SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-86031; File No. S7-07-18]

RIN 3235-AM35

Regulation Best Interest: The Broker-Dealer Standard of Conduct

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (the "Commission") is adopting 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 (unless otherwise indicated, together referred to as "broker-dealer") when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities ("Regulation Best Interest"). Regulation Best Interest enhances the broker-dealer standard of conduct beyond existing suitability obligations, and aligns the standard of conduct with retail customers' reasonable expectations by requiring broker-dealers, among other things, to: (1) 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 ahead of the interests of the retail customer; and (2) address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest, and in instances where we have determined that disclosure is insufficient to reasonably address the conflict, to mitigate or, in certain instances, eliminate the conflict. The standard of conduct established by Regulation Best Interest cannot be satisfied through disclosure alone. The standard of conduct draws from key principles underlying fiduciary obligations, including those that apply to investment advisers under the

Investment Advisers Act of 1940 ("Advisers Act"). Importantly, regardless of whether a retail investor chooses a broker-dealer or an investment adviser (or both), the retail investor will be entitled to a recommendation (from a broker-dealer) or advice (from an investment adviser) that is in the best interest of the retail investor and that does not place the interests of the firm or the financial professional ahead of the interests of the retail investor.

DATES: *Effective Date*: This rule is effective [insert date 60 days after date of publication in the Federal Register].

Compliance Date: The compliance date is discussed in Section II.E of this final release.

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SUPPLEMENTARY INFORMATION: The Commission is adopting new rule 17 CFR 240.15*l*-1 under the Exchange Act to establish a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities. The Commission is also adopting amendments to rules 17 CFR 240.17a-3 and 17 CFR 240.17a-4 to establish new record-making and recordkeeping requirements for broker-dealers with respect to certain information collected from or provided to retail customers.

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I. INTRODUCTION

We are adopting a new rule 15*l*-1under the Exchange Act ("Regulation Best Interest") that will improve investor protection by: (1) enhancing the obligations that apply when a broker-dealer makes a recommendation to a retail customer and natural persons who are associated persons of a broker-dealer ("associated persons") (unless otherwise indicated, together referred to as "broker-dealer") and (2) reducing the potential harm to retail customers from conflicts of interest that may affect the recommendation. Regulation Best Interest enhances the broker-dealer standard of conduct beyond existing suitability obligations, and aligns the standard of conduct with retail customers' reasonable expectations by requiring broker-dealers, among other things, to: (1) 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 ahead of the interests of the retail customer; and (2) address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest, and in instances where we have determined that disclosure is insufficient to reasonably address the conflict, to mitigate or, in certain instances, eliminate the conflict. Regulation Best Interest establishes a standard of conduct under the Exchange Act that cannot be satisfied through disclosure alone.

A. Background

Broker-dealers play an important role in helping Americans organize their finances, 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 offer a wide variety of brokerage (i.e., agency) services and dealer (i.e., principal) services and products to both retail and institutional customers.[1] Specifically, the brokerage services provided to retail customers range from execution-only services to providing personalized investment advice in the form of recommendations of securities transactions or investment strategies involving securities to customers.[2]

Investment advisers play a similarly important, though distinct, role. As described in the Fiduciary Interpretation, investment advisers provide a wide range of services to a large variety of clients, from retail clients with limited assets and investment knowledge and experience to

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1 *See* Regulation Best Interest, Release No. 34-83062 (Apr. 18, 2018) [83 FR 21574] (May 9, 2018) ("Proposing Release") at 21574-75; *see also* 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 8-12, *available at* www.sec.gov/news/studies/2011/913studyfinal.pdf (discussing the range of brokerage and dealer services provided by broker-dealers).

2 *See* Proposing Release at 21574-21575; *see also* 913 Study.

institutional clients with very large portfolios and substantial knowledge, experience, and analytical resources.[3]

As a general matter, broker-dealers and investment advisers have different types of relationships with investors, offer different services, and have different compensation models when providing investment recommendations or investment advisory services to customers. Broker-dealers typically provide transaction-specific recommendations and receive compensation on a transaction-by-transaction basis (such as commissions) ("transaction-based" compensation or model). A broker-dealer's recommendations may include recommending transactions where the broker-dealer is buying securities from or selling securities to retail customers on a principal basis or recommending proprietary products.[4] Investment advisers, on the other hand, typically provide ongoing, regular advice and services in the context of broad investment portfolio management, and are compensated based on the value of assets under management ("AUM"), a fixed fee or other arrangement ("fee-based" compensation or model).[5] This variety is important because it presents investors with choices regarding the types of relationships they can have, the services they can receive, and how they can pay for those

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3 *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019) ("Fiduciary Interpretation").

4 *See* Proposing Release at 21574-21575; *see also* 913 Study.

5 *See* 913 Study.

services. It is also common for a firm to provide both broker-dealer and investment adviser services.

Like many principal-agent relationships—including the investment adviser-client relationship—the relationship between a broker-dealer and a customer has inherent conflicts of interest, including those resulting from a transaction-based (e.g., commission) compensation structure and other broker-dealer compensation.[6] These and other conflicts of interest may provide an incentive to a broker-dealer to seek to increase its own compensation or other financial interests at the expense of the customer to whom it is making investment recommendations.

Notwithstanding these inherent conflicts of interest in the broker-dealer-customer relationship, there is broad acknowledgment of the benefits of, and support for, the continuing existence of the broker-dealer business model, including a commission or other transaction-based compensation structure, as an option for retail customers seeking investment recommendations.[7] For example, retail customers that intend to buy and hold a long-term investment may find that paying a one-time commission to a broker-dealer recommending such an investment is more cost

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6 The investment adviser-client relationship also has inherent conflicts of interest, including those resulting from an asset-based compensation structure that may provide an incentive for an investment adviser to encourage its client to invest more money through an adviser in order increase its AUM at the expense of the client. *See* Fiduciary Interpretation at footnotes 53-72 and accompanying text for a discussion of how investment advisers satisfy their fiduciary duty when conflicts of interest are present.

7 *See* Proposing Release at 21579.

effective than paying an ongoing advisory fee to an investment adviser merely to hold the same investment. Retail customers with limited investment assets may benefit from broker-dealer recommendations when they do not qualify for advisory accounts because they do not meet the account minimums often imposed by investment advisers. Other retail customers who hold a variety of investments, or prefer differing levels of services (e.g., both episodic recommendations from a broker-dealer and continuous advisory services including discretionary asset management from an investment adviser), may benefit from having access to both brokerage and advisory accounts. Nevertheless, concerns exist regarding (1) the potential harm to retail customers resulting from broker-dealer recommendations provided where conflicts of interest exist and (2) the insufficiency of existing broker-dealer regulatory requirements to address these conflicts when broker-dealers make recommendations to retail customers.[8] More specifically, there are concerns that existing requirements do not require a broker-dealer's recommendations to be in the retail customer's best interest.[9]

B. Overview of Regulation Best Interest

On April 18, 2018, we proposed enhancements to the standard of conduct that applies when broker-dealers make recommendations to retail customers.[10] Specifically, the proposal

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8 *Id*. at 21577-21579.

9 *Id. See also* Section I.C, Overview of Modifications to the Proposed Rule Text and Guidance Provided.

10 Proposing Release at 21575.

would have established an express best interest obligation that would require all broker-dealers and associated persons, 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 associated person making the recommendation ahead of the interest of the retail customer.

The Commission received substantial comment on proposed Regulation Best Interest. We received over 6,000 comment letters in connection with the Proposing Release, of which approximately 3,000 are unique comment letters, from a variety of commenters including individual investors, consumer advocacy groups, financial services firms (including broker-dealers, investment advisers, and insurance companies), investment professionals, industry and trade associations, state securities regulators, bar associations, and others.[11]

The Commission also solicited individual investors' input through a number of forums in addition to the traditional requests for comment in the Proposing Release. Among other things, seven investor roundtables were held in different locations across the country to solicit further comment on the proposed relationship summary,[12] and the Commission and its staff received in-

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[11] Comments received in response to the Proposing Release are available at: https://www.sec.gov/comments/s7-07-18/s70718.htm.

[12] In a separate, concurrent rulemaking, the Commission proposed to, among other things, require broker-dealers and investment advisers to deliver to retail investors a short relationship summary ("Relationship Summary"). *See Form CRS Relationship Summary;*

person feedback from almost 200 attendees in total.[13] The Commission also received input and recommendations from a majority of its Investor Advisory Committee ("IAC") on proposed Regulation Best Interest.[14]

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 (Apr. 18, 2018), 83 FR 23848 (May 23, 2018) ("Relationship Summary Proposal").

Along with adopting Regulation Best Interest, the Commission is adopting Exchange Act Rule 17a-14 (CFR 240.17a-14) and Form CRS (17 CFR 249.640) under the Exchange Act ("Form CRS"). *See Form CRS Relationship Summary; Amendments to Form ADV* Exchange Act Release No. 86032, Advisers Act Release No. 5247, File No. S7-08-18 (June 5, 2019) ("Relationship Summary Adopting Release"). The Commission is also providing interpretations: (1) clarifying standards of conduct for investment advisers, and (2) regarding when a broker-dealer's advisory services are solely incidental to the conduct of the business of a broker or dealer. *See* Fiduciary Interpretation; Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion to the Definition of Investment Adviser, Advisers Act Release No. 5249 (June 5, 2019) ("Solely Incidental Interpretation").

[13] The transcripts from the seven investor roundtables, which took place in Atlanta, Baltimore, Denver, Houston, Miami, Philadelphia, and Washington D.C., are available in the comment file at https://www.sec.gov/comments/s7-08-18/s70818.htm#transcripts.

The Commission also used a "feedback form" designed specifically to solicit input from retail investors with a set of questions requesting both structured and narrative responses, and received more than 90 responses from individuals who reviewed and commented on the sample proposed relationship summaries published in the proposal. The feedback forms are available in the comment file at https://www.sec.gov/comments/s7-08-18/s70818.htm.

Finally, the Commission's Office of the Investor Advocate engaged the RAND Corporation to conduct investor testing of the proposed relationship summary. Angela A. Hung, *et al.*, RAND Corporation, *Investor Testing of Form CRS Relationship Summary* (2018), *available at* https://www.sec.gov/about/offices/investorad/investor-testing-form-

After careful review and consideration of comments received and upon further consideration, the Commission is adopting Regulation Best Interest, with certain modifications

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crs-relationship-summary.pdf ("RAND 2018"). *See also Investor Testing of the Proposed Relationship Summary for Investment Advisers and Broker-Dealers*, Commission Press Release 2018-257 (Nov. 7, 2018), *available at* https://www.sec.gov/news/press-release/2018-257. As noted in the Relationship Summary Adopting Release, the amount of information available from the various investor surveys and investor testing described in this release is extensive. We considered all of this information thoroughly, using our decades of experience with investor disclosures, when evaluating changes to the disclosure required by Regulation Best Interest, as well as to the Relationship Summary. *See* Relationship Summary Adopting Release.

[14] Recommendation of the Investor as Purchaser Subcommittee Regarding Proposed Regulation Best Interest, Form CRS, and Investment Advisers Act Fiduciary Guidance, Nov. 7, 2018, *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac110718-investor-as-purchaser-subcommittee-recommendation.pdf ("IAC 2018 Recommendation"). Generally, a majority of the IAC made the following recommendations related to Regulation Best Interest: (1) that the meaning of the best interest obligation should be clarified to require both broker-dealers, investment advisers, and their associated persons to recommend the investments, investment strategies, accounts, or services, from among those they have reasonably available to recommend, that they reasonably believe represent the best available options for the investor; (2) that the best interest obligation be expanded to apply to the implicit "no recommendation" recommendation that a broker makes when reviewing an account and recommending no change, to rollover recommendations and recommendations by dual registrant firms regarding account types; and (3) that the best interest obligation should be explicitly characterized as the fiduciary duty that it is, while making clear that the specific obligations that flow from that duty will vary based on differences in business models. The Commission is statutorily obligated to respond to the recommendations of the IAC, which we are doing in this section and throughout the adopting release in the relevant sections, for example, in the discussion of the General Obligation in Section II.A.1, the discussion of recommendations in Section II.B.1, Recommendation of Any Securities Transaction or Investment Strategy Involving Securities, and the Care Obligation in Section II.C.2.

as compared to the Proposing Release. As discussed below, while the Commission is generally retaining the overall structure and scope set forth in the Proposing Release, we are making modifications to the text of the rule and also providing interpretations and guidance to address points raised during the comment process.

The Commission has crafted Regulation Best Interest to draw on key principles underlying fiduciary obligations, including those that apply to investment advisers under the Advisers Act, while providing specific requirements to address certain aspects of the relationships between broker-dealers and their retail customers. Regulation Best Interest enhances the existing standard of conduct applicable to broker-dealers and their associated persons at the time they recommend to a retail customer a securities transaction or investment strategy involving securities. This includes recommendations of account types and rollovers or transfers of assets and also covers implicit hold recommendations resulting from agreed-upon account monitoring. When making a recommendation, a broker-dealer must act in the retail customer's best interest and cannot place its own interests ahead of the customer's interests (hereinafter, "General Obligation").[15] The General Obligation is satisfied only if the broker-dealer complies with four specified component obligations. The obligations are: (1) providing certain prescribed disclosure before or at the time of the recommendation, about the recommendation and the relationship between the retail customer and the broker-dealer

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15 *See generally* Section II.A, General Obligation.

("Disclosure Obligation"); (2) exercising reasonable diligence, care, and skill in making the recommendation ("Care Obligation"); (3) establishing, maintaining, and enforcing policies and procedures reasonably designed to address conflicts of interest ("Conflict of Interest Obligation"), and (4) establishing, maintaining, and enforcing policies and procedures reasonably designed to achieve compliance with Regulation Best Interest ("Compliance Obligation").[16]

First, under the Disclosure Obligation,[17] before or at the time of the recommendation, a broker-dealer must disclose, in writing, all material facts about the scope and terms of its relationship with the customer. This includes a disclosure that the firm or representative is acting in a broker-dealer capacity; the material fees and costs the customer will incur; and the type and scope of the services to be provided, including any material limitations on the recommendations that could be made to the retail customer. Moreover, the broker-dealer must disclose all material facts relating to conflicts of interest associated with the recommendation that might incline a broker-dealer to make a recommendation that is not disinterested, including, for example,

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[16] As discussed in further detail below, although Regulation Best Interest identifies specified obligations with which a broker-dealer must comply in order to meet its General Obligation, compliance with each of the component obligations of Regulation Best Interest will be principles-based. In other words, whether a broker-dealer has acted in the retail customer's best interest will turn on an objective assessment of the facts and circumstances of whether the specific components of Regulation Best Interest are satisfied at the time that the recommendation is made.

[17] *See generally* Section II.C.1, Disclosure Obligation.

conflicts associated with proprietary products, payments from third parties, and compensation arrangements.

Second, under the Care Obligation,[18] a broker-dealer must 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 those risks, rewards, and costs in light of the customer's investment profile and have a reasonable basis to believe that the recommendation is in the customer's best interest and does not place the broker-dealer's interest ahead of the retail customer's interest. A broker-dealer should consider reasonable alternatives, if any, offered by the broker-dealer in determining whether it has a reasonable basis for making the recommendation. Whether a broker-dealer has complied with the Care Obligation will be evaluated as of the time of the recommendation (and not in hindsight). When recommending a series of transactions, the broker-dealer must have a reasonable basis to believe that the transactions taken together are not excessive, even if each is in the customer's best interest when viewed in isolation.

Third, under the Conflict of Interest Obligation,[19] a broker-dealer must establish, maintain, and enforce reasonably designed written policies and procedures addressing conflicts of interest associated with its recommendations to retail customers. These policies and

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[18] *See generally* Section II.C.2, Care Obligation.

[19] *See generally* Section II.C.3, Conflict of Interest Obligation.

procedures must be reasonably designed to identify all such conflicts and at a minimum disclose or eliminate them. Importantly, the policies and procedures must be reasonably designed to mitigate conflicts of interests that create an incentive for an associated person of the broker-dealer to place its interests or the interest of the firm ahead of the retail customer's interest. Moreover, when a broker-dealer places material limitations on recommendations that may be made to a retail customer (e.g., offering only proprietary or other limited range of products), the policies and procedures must be reasonably designed to disclose the limitations and associated conflicts and to prevent the limitations from causing the associated person or broker-dealer from placing the associated person's or broker-dealer's interests ahead of the customer's interest. Finally, the policies and procedures must be reasonably designed to identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.

Fourth, under the Compliance Obligation,[20] a broker-dealer must also establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest as a whole. Thus, a broker-dealer's policies and procedures must address not only conflicts of interest but also compliance with its Disclosure and Care Obligations under Regulation Best Interest.

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[20] *See generally* Section II.C.4, Compliance Obligation.

The enhancements contained in Regulation Best Interest are designed to improve investor protection by enhancing the quality of broker-dealer recommendations to retail customers and reducing the potential harm to retail customers that may be caused by conflicts of interest. Regulation Best Interest will complement the related rules, interpretations, and guidance that the Commission is concurrently issuing.[21] Individually and collectively, these actions are designed to help retail customers better understand and compare the services offered by broker-dealers and investment advisers and make an informed choice of the relationship best suited to their needs and circumstances, provide clarity with respect to the standards of conduct applicable to investment advisers and broker-dealers, and foster greater consistency in the level of protections provided by each regime, particularly at the point in time that a recommendation is made.[22]

At the time a recommendation is made, key elements of the Regulation Best Interest standard of conduct that applies to broker-dealers will be similar to key elements of the fiduciary standard for investment advisers.[23] Importantly, regardless of whether a retail investor chooses a broker-dealer or an investment adviser (or both), the retail investor will be entitled to a

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21 *See* Relationship Summary Adopting Release; Fiduciary Interpretation; Solely Incidental Interpretation.

22 We believe each rule and interpretation stands on its own and enhances the effectiveness of existing rules, and is reinforced by the other rules and interpretations being adopted contemporaneously.

23 Specifically, an investment adviser's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty. This combination of care and loyalty obligations has been characterized as requiring the investment adviser to act in the "best interest" of its client at all times. *See* Fiduciary Interpretation.

recommendation (from a broker-dealer) or advice (from an investment adviser) that is in the best interest of the retail investor and that does not place the interests of the firm or the financial professional ahead of the interests of the retail investor.

There are also key differences between Regulation Best Interest and the Advisers Act fiduciary standard that reflect the distinction between the services and relationships typically offered under the two business models. For example, an investment adviser's fiduciary duty generally includes a duty to provide ongoing advice and monitoring,[24] while Regulation Best Interest imposes no such duty and instead requires that a broker-dealer act in the retail customer's best interest *at the time* a recommendation is made. In addition, the new obligations applicable to broker-dealers under Regulation Best Interest are more prescriptive than the obligations applicable to investment advisers under the Advisers Act fiduciary duty and reflect the characteristics of the generally applicable broker-dealer business model.[25]

The Commission has been studying and carefully considering the issues related to the standard of conduct for broker-dealers for many years, which led to the development of Regulation Best Interest.[26] In designing Regulation Best Interest, we considered a number of options to enhance investor protection, while preserving, to the extent possible, retail investor

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24 *See* Fiduciary Interpretation, Section II.B.3 (Duty to Provide Advice and Monitoring over the Course of the Relationship).

25 *See, e.g.*, Sections II.A and III.E.

26 Proposing Release at 21579-21583.

access (in terms of choice and cost) to differing types of investment services and products. There were several options, including, among others: (1) applying the fiduciary standard under the Advisers Act to broker-dealers; (2) adopting a "new" uniform fiduciary standard of conduct that would apply equally to both broker-dealers and investment advisers, such as that recommended by the staff in the 913 Study;[27] and (3) the path we ultimately chose, adopting a new standard of conduct specifically for broker-dealers, which draws from key principles underlying fiduciary obligations, including those that apply to investment advisers under the Advisers Act.[28] The standard also provides specific requirements to address certain aspects of

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[27] 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." 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. *See generally* 913 Study.

[28] *See supra* footnote 23.

the relationships between broker-dealers and their retail customers, including certain conflicts related to compensation of associated persons.[29]

We have declined to subject broker-dealers to a wholesale and complete application of the existing fiduciary standard under the Advisers Act because it is not appropriately tailored to the structure and characteristics of the broker-dealer business model (i.e., transaction-specific recommendations and compensation), and would not properly take into account, and build upon, existing obligations that apply to broker-dealers, including under FINRA rules.[30] Moreover, we believe (and our experience indicates), that this approach would significantly reduce retail investor access to differing types of investment services and products, reduce retail investor choice in how to pay for those products and services, and increase costs for retail investors of obtaining investment recommendations.[31]

We have also declined to craft a new uniform standard that would apply equally and without differentiation to both broker-dealers and investment advisers. Adopting a "one size fits all" approach would risk reducing investor choice and access to existing products, services, service providers, and payment options, and would increase costs for firms and for retail

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29 In addition to these alternatives, we also considered several other reasonable alternatives. *See* Section III.E.

30 *See also* 913 Study at 139-143.

31 *See, e.g.*, Section 913 Study. at 143-159 for the study's consideration of the potential costs, expenses, and impacts of various regulatory changes related to the provision of personalized investment advice to retail investors. *See also* Section II.A.1, Commission's Approach.

investors in both broker-dealer and investment adviser relationships. Moreover, applying a new uniform standard to advisers would mean jettisoning to some extent the fiduciary standard under the Advisers Act that has worked well for retail clients and our markets and is backed by decades of regulatory and judicial precedent.

Our concerns about the ramifications for investor access, choice, and cost from adopting either of these approaches are not theoretical. With the adoption of the now vacated Department of Labor ("DOL") Fiduciary Rule,[32] there was a significant reduction in retail investor access to

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[32] As discussed in more detail in the Proposing Release, on April 8, 2016, the 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 a plan subject to the Employee Retirement Income Security Act of 1974 ("ERISA") (an "ERISA plan") or individual retirement account ("IRA") as fiduciaries in a wider array of advice relationships than under the previous regulation and issued certain related prohibited transaction exemptions ("PTEs") (together, the "DOL Fiduciary Rule"). The rule was subsequently vacated in toto by the United States Court of Appeals for the Fifth Circuit. *See Chamber of Commerce v. U.S. Dep't of Labor, 885 F.3d 360* (5th Cir. 2018).

We understand that in the absence of a PTE, broker-dealers that would be considered to be a "fiduciary" for purposes of ERISA and the Internal Revenue Code (the "Code") would be prohibited from engaging in purchases and sales of certain investments for their own account (*i.e.,* engaging in principal transactions) and would be prohibited from receiving common forms of broker-dealer compensation (notably, transaction-based compensation). *See* DOL, Best Interest Contract Exemption, 81 FR 21002 (Apr. 8, 2016) ("BIC Exemption Release"). To avoid this result, the DOL published, among other PTEs, the Best Interest Contract Exemption ("BIC Exemption"), which would have provided conditional relief for an "adviser," as that term is used in the context of the BIC Exemption, 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 met certain conditions. *See id*. Generally, the BIC Exemption and other PTEs required that, among other things, the advice be provided pursuant to a written contract that commits the firm and the adviser to adhere to standards

brokerage services,[33] and we believe that the available alternative services were higher priced in many circumstances.[34] Moreover, because key elements of the standard of conduct that

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of impartial conduct, including 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"). *See generally id*. *See also* Proposing Release at 21580-21582.

33 While the full effects of the DOL Fiduciary Rule were not realized as it was vacated during the transition period, a number of industry studies indicated that, as a result of the DOL Fiduciary Rule, industry participants had already or were planning to alter services and products available to retail customers. For example, of the 21 members of the Securities Industry and Financial Markets Association ("SIFMA") that participated in the SIFMA Study, 53% eliminated or reduced access to brokerage advice services and 67% migrated away from open choice to fee-based or limited brokerage services. *See* SIFMA & Deloitte, *The DOL Fiduciary Rule: A Study on How Financial Institutions Have Responded and the Resulting Impacts on Retirement Investors* (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"). Other studies also saw shifts from commission-based accounts to fee-based accounts. *See infra* footnote 1009. In addition, an industry study found that some customers were shifted from commission-based brokerage accounts to self-directed accounts, while the same study observed that 29% of their survey participants expected to move clients, particularly those with low account balances, to robo-advisors. *See infra* footnote 1010.

34 It was widely reported that a number of firms responded to the DOL Fiduciary Rule by either requiring customers to enter into more expensive advice relationships or by passing through higher compliance costs to customers, which altered many retail customer relationships with their financial professionals. *See infra* footnote 1007. From the SIFMA Study, for those firms whose retail customers faced eliminated or reduced brokerage advice services, 63% of firms had customers that chose to move to self-directed accounts rather than fee-based accounts and cited the customers' 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."

Regulation Best Interest applies to broker-dealers at the time that a recommendation is made to a retail customer will be substantially similar to key elements of the standard of conduct that applies to investment advisers pursuant to their fiduciary duty under the Advisers Act, we do not believe that applying the existing fiduciary standard under the Advisers Act to broker-dealers or adopting a new uniform fiduciary standard of conduct applicable to both broker-dealers and investment advisers would provide any greater investor protection (or, in any case, that any benefits would justify the costs imposed on retail investors in terms of reduced access to services, products, and payment options, and increased costs for such services and products).

We acknowledge certain commenters urged the Commission to take additional or different regulatory actions than the approach we have adopted, including the alternatives discussed above. We do not believe that any rulemaking governing retail investor-advice relationships can solve for every issue presented. After careful consideration of the comments and additional information we have received,[35] we believe that Regulation Best Interest, as modified, appropriately balances the concerns of the various commenters in a way that will best achieve the Commission's important goals of enhancing retail investor protection and decision making, while preserving, to the extent possible, retail investor access (in terms of choice and cost) to differing types of investment services and products.[36]

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35 *See supra* footnotes 11-13 and accompanying text.

36 If any of the provisions of these rules, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or

The Commission's staff will offer firms significant assistance and support during the transition period and thereafter with the aim of helping to ensure that the investor protections and other benefits of the final rule are implemented in an efficient and effective manner. Further, we will continue to monitor the effectiveness of Regulation Best Interest in achieving the Commission's goals.

C. Overview of Modifications to the Proposed Rule Text and Guidance Provided

The vast majority of commenters supported the Commission's rulemaking efforts to address the standards of conduct that apply to broker-dealers when making recommendations, but nearly all commenters suggested modifications to proposed Regulation Best Interest.[37] These suggestions touch on almost every aspect of the proposal, as discussed in more detail below. A variety of commenters offered suggestions on the overall structure and scope of the

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application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

37 *See, e.g.*, Letter from David Certner, Legislative Counsel and Legislative Policy Director, AARP (Aug. 7, 2018) ("AARP August 2018 Letter"); Letter from Christopher Gilkerson, Senior Vice President and General Counsel, and Tara Tune, Director and Corporate Counsel, Charles Schwab & Co., Inc. (Aug. 6, 2018) ("Schwab Letter"); Letter from Barbara Roper, Director of Investor Protection, and Micah Hauptman, Financial Services Counsel, Consumer Federation of America ("CFA") (Aug. 7, 2018) ("CFA August 2018 Letter"); Letter from Joseph Borg, President, North American Securities Administrators Association, Inc. ("NASAA") (Aug. 23, 2018) ("NASAA August 2018 Letter"); Letter from Kenneth E. Bentsen, Jr., President and Chief Executive Officer, SIFMA (Aug. 7, 2018) ("SIFMA August 2018 Letter").

proposed rule, including: whether the standard should be a fiduciary standard;[38] whether the standard should apply to both investment advisers and broker-dealers;[39] whether the standard should be principles-based or more prescriptive;[40] whether the standard should define "best

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[38] *See, e.g.,* Letter from Jon Stein, Founder and CEO, Benjamin T. Alden, General Counsel, and Seth Rosenbloom, Associate General Counsel, Betterment (Aug. 7, 2018) ("Betterment Letter"); Letter from Kurt N. Schacht, Managing Director, James Allen, Head, Capital Markets Policy, and Linda L. Rittenhouse, Director, Capital Markets, CFA Institute (Aug. 7, 2018) ("CFA Institute Letter"); Letter from Jill I. Gross, Associate Dean for Academic Affairs, Professor of Law, Elisabeth Haub School of Law, Pace University (Mar. 11, 2019) ("Pace March 2019 Letter"); Letter from Sharon Cheever, Senior Vice President and General Counsel, Pacific Life Insurance Company (Aug. 3, 2018) ("Pacific Life August 2018 Letter"); Letter from Melanie Fein, Fein Law Offices (Jun. 6, 2018) ("Fein Letter"); Letter from Elizabeth Warren, U.S. Senator (Aug. 3, 2018) ("Warren Letter"); Letter from Dean P. McDermott, McDermott Investment Advisors (Jul. 7, 2018) ("McDermott Letter"); Letter from Brian Hamburger, President and CEO, MarketCounsel (Aug. 7, 2018) ("MarketCounsel Letter").

[39] *See, e.g.*, AARP August 2018 Letter; Letter from Americans for Financial Reform et al. (Aug. 7, 2018) ("Americans for Financial Reform Letter"); Letter from Robert J. Moore, Chief Executive Officer, Cetera Financial Group ("Cetera") (Aug. 7, 2018) ("Cetera August 2018 Letter"); Letter from L.A. Schnase, Individual Investor and Attorney at Law (Jul. 30, 2018) ("Schnase Letter"); Pacific Life August 2018 Letter; Pace March 2019 Letter; MarketCounsel Letter; Letter from Dennis M. Kelleher, President and CEO, Stephen Hall, Legal Director and Securities Specialist, Lev Bagramian, Senior Securities Policy Advisor, Better Markets (Aug. 7, 2018) ("Better Markets August 2018 Letter"); Letter from Attorneys General of New York, California, Connecticut, Delaware, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Mexico, Oregon, Pennsylvania, Rhode Island, Vermont, Washington, and the District of Columbia (Aug. 7, 2018) ("State Attorneys General Letter").

[40] *See, e.g.*, SIFMA August 2018 Letter; Letter from Mortimer J. Buckley, President and Chief Executive Officer, Vanguard (Aug. 7, 2018) ("Vanguard Letter"); Letter from Chris Lewis, General Counsel, Edward Jones (Aug. 7, 2018) ("Edward Jones Letter"); Letter from Joseph E. Sweeney, President, Advice & Wealth Management Products and Service Delivery, Ameriprise Financial (Aug. 6, 2018) ("Ameriprise Letter"); Letter from

interest;"[41] whether the standard is or should be a safe harbor;[42] what should be considered a recommendation, including whether Regulation Best Interest should apply to recommendations to roll over or transfer assets or take plan distributions, and to recommendations of particular account types (i.e., brokerage or advisory);[43] whether Regulation Best Interest should apply to

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Sheila Kearney Davidson, Executive Vice President, Chief Legal Officer & General Counsel, New York Life Insurance Company ("NY Life") (Aug. 7, 2018) ("NY Life Letter"); Letter from Keith Gillies, NAIFA President, National Association of Insurance and Financial Advisors ("NAIFA") (Aug. 2, 2018) ("NAIFA Letter"); Letters from Tom Quaadman, Executive Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce ("CCMC") (Aug. 7, 2018) (supplemented by letter dated Sep. 5, 2018) ("CCMC Letters"); Letter from Dave Paulsen, Executive Vice President, Chief Distribution Officer, Transamerica (Aug. 7, 2018) ("Transamerica August 2018 Letter").

41 *See, e.g.*, Letter from Seth A. Miller, General Counsel, Senior Vice President, Chief Risk Officer, Cambridge (Aug. 7, 2018) ("Cambridge Letter"); SIFMA August 2018 Letter; Vanguard Letter; Edward Jones Letter; Ameriprise Letter; NY Life Letter; NAIFA Letter; CCMC Letters; Letter from Aron Szapiro, Director of Policy Research, Morningstar (Aug. 7, 2018) ("Morningstar Letter"); Letter from David Kowach, Head of Wells Fargo Advisors, Wells Fargo (Aug. 7, 2018) ("Wells Fargo Letter").

42 *See, e.g.*, CFA August 2018 Letter; Letter from Anthony Chereso, President & CEO, Institute for Portfolio Alternatives ("IPA") (Aug. 7, 2018) ("IPA Letter"); Letter from Heather Slavkin Corzo, AFL-CIO et al. (Apr. 26, 2019*)* ("AFL-CIO April 2019 Letter").

43 *See, e.g.*, Letter from Jason Bortz, Senior Counsel, Capital Research and Management Company (Aug. 7, 2018) ("Capital Group Letter"); Letter from Andrew Stoltmann, President, Public Investors Arbitration Bar Association ("PIABA") (Aug. 7, 2018) ("PIABA Letter"); SIFMA August 2018 Letter; NASAA Letter; Letter from Robert K. Shaw, President, Individual Markets, Great-West Financial (Aug. 7, 2018) ("Great-West Letter"); NAIFA Letter; Transamerica August 2018 Letter; Letter from Tim Rouse, Executive Director, The SPARK Institute (Aug. 7, 2018) ("SPARK Letter"); Letter from Robin C. Swope, Director, Global Product Governance & Support, Invesco (Aug. 7, 2018) ("Invesco Letter"); Letter from R. Keith Overly, President, National Association of Government Defined Contribution Administrators ("NAGDCA") (Aug. 7, 2018) ("NAGDCA Letter"); Letter from Kevin R. Keller, Chief Executive Officer, CFP Board,

account monitoring services provided by a broker-dealer, or impose a continuing duty;[44] and whether Regulation Best Interest's protections should apply to a broader or narrower set of "retail customers."[45]

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et al., Financial Planning Coalition ("FPC") (Aug. 7, 2018) ("FPC Letter"); Letter from Dennis Simmons, Executive Director, Committee on Investment of Employee Benefit Assets, Committee on Investment of Employee Benefit Assets ("CIEBA") (Aug. 6, 2018) ("CIEBA Letter").

44 *See, e.g.*, SIFMA August 2018 Letter; Letter from Lisa D. Crossley, Executive Director, National Society of Compliance Professionals ("NSCP") (Aug. 7, 2018) ("NSCP Letter"); PIABA Letter; FPC Letter; Better Markets August 2018 Letter; Letter from Karen L. Barr, President and CEO, Investment Adviser Association ("IAA") (Aug. 6, 2018) ("IAA August 2018 Letter").

We also received comments addressing when a broker-dealer's advisory services are "solely incidental to the conduct of his business as a broker or dealer" under the "broker-dealer exclusion" from the definition of investment adviser—and thus from the application of the Advisers Act—provided in Section 202(a)(11)(C) of the Advisers Act. We have addressed these comments in the context of the Solely Incidental Interpretation.

45 *See, e.g.*, Letter from Carl B. Wilkerson, Vice President and Chief Counsel, American Council of Life Insurers ("ACLI") (Aug. 3, 2018) ("ACLI Letter"); Letter from Brian H. Graff, Executive Director and CEO, Craig P. Hoffman, General Counsel, Dough Fisher, Director of Retirement Policy, and Joseph A. Caruso, Government Affairs Counsel, American Retirement Association ("ARA") (Aug. 3, 2018) ("ARA August 2018 Letter"); Letter from Anne Tennant, Managing Director and General Counsel, Morgan Stanley (Aug. 7, 2018) ("Morgan Stanley Letter"); CCMC Letters; Letter from Thomas Roberts, Groom Law Group (Aug. 7, 2018) ("Groom Letter"); Letter from Catherine J. Weatherford, President and CEO, Insured Retirement Institute ("IRI") (Aug. 7, 2018) ("IRI Letter"); NSCP Letter; Letter from Raymond J. Manista, Executive Vice President, Chief Legal Officer and Secretary, Northwestern Mutual (Aug. 7, 2018) ("Northwestern Mutual Letter"); State Attorneys General Letter; Letter from Mari-Anne Pisarri, Pickard Djinis and Pisarri LLP (Aug. 14, 2018) ("Pickard Letter"); SIFMA August 2018 Letter; Invesco Letter; Letter from Tom Clark, Managing Director, Sean Murphy, Vice President, Blackrock (Aug. 7, 2018) ("Blackrock Letter").

In addition, most commenters from both industry and consumer advocate groups requested modifications to each of the Disclosure, Care, and Conflict of Interest Obligations, and also called for more specific examples of conduct that would—or would not—satisfy these obligations. With respect to the Disclosure Obligation, most commenters generally sought greater clarity or made suggestions regarding what material facts and material conflicts would need to be disclosed, the form and manner (e.g., written versus oral, individualized versus standardized, and the use of electronic and/or layered) and the timing and frequency of the disclosure (e.g., whether the disclosure should be prior to, at the time of, or could be after a recommendation), as well as whether the Disclosure Obligation could be satisfied by complying with other existing disclosure requirements.[46] In particular, several commenters recommended that the Commission require broker-dealers provide "full and fair" disclosure.[47]

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[46] *See, e.g.*, Ameriprise Letter; Great-West Letter; Letter from Ram Subramaniam, Head of Brokerage and Investment Solutions, David Forman, Chief Legal Officer, Fidelity Investments (Aug. 7, 2018) ("Fidelity Letter"); Morgan Stanley Letter; CCMC Letters; Letter from Bret C. Hester, Senior Managing Director, Head of Regulatory Affairs, Teachers Insurance and Annuity Association of America ("TIAA") (Aug. 7, 2018) ("TIAA Letter"); Letter from James Sonne, Assistant Vice President, Federal Government Relations, Mass Mutual (Feb. 19, 2019) ("Mass Mutual Letter"); Letter from Edmund F. Murphy III, President, Empower Retirement (Aug. 2, 2018) ("Empower Retirement Letter"); IRI Letter; Letter from Paul Schott Stevens, President and CEO, Investment Company Institute ("ICI") (Aug. 7, 2018) ("ICI Letter"); SIFMA August 2018 Letter; Edward Jones Letter; Letter from Michelle Bryan Oroschakoff, Chief Legal Officer, LPL Financial (Aug. 7, 2018) ("LPL August 2018 Letter"); NASAA August 2018 Letter; AARP August 2018 Letter; PIABA Letter; Letter from Ann M. Kappler, Senior Vice President, Deputy General Counsel, Prudential Financial (Aug. 7, 2018) ("Prudential Letter"), CFA Institute Letter; State Attorneys General Letter; CFA August

Regarding the Care Obligation, commenters from certain investor groups supported incorporating a "prudence" standard,[48] while a number of industry commenters expressed concern about including this standard.[49] Numerous commenters requested further clarity on what would be required to meet the Care Obligation, including what factors a broker-dealer should consider in developing a retail customer's investment profile and when making a recommendation, and in particular the role of cost and other relevant factors when making a recommendation, and also asked for more specific examples of how to weigh costs against other factors when making a recommendation.[50] A majority of the IAC and other commenters requested clarification on how to consider "reasonably available alternatives" when making a

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2018 Letter; Letter from Jason Chandler, Group Managing Director, Co-Head Investment Platforms and Solutions, and Michael Crowl, Group Managing Director, General Counsel, UBS (Aug. 7, 2018) ("UBS Letter"), Letter from William F. Galvin, Secretary of the Commonwealth of Massachusetts (Aug. 7, 2018) ("Galvin Letter"); Letter from David T. Bellaire, Executive Vice President & General Counsel, Financial Services Institute ("FSI") (Aug. 7, 2018) ("FSI August 2018 Letter"); Mass Mutual Letter; Schwab Letter; Letter from Michael F. Anderson, Senior Vice President and Chief Legal Officer, CUNA Mutual (Aug. 7, 2018) ("CUNA Letter"); Transamerica August 2018 Letter.

47 *See, e.g.*, CFA August 2018 Letter; Better Markets August 2018 Letter; Pace Letter.

48 *See, e.g.*, AARP August 2018 Letter; CFA August 2018 Letter; FPC Letter.

49 *See, e.g.*, Letter from Karen L. Sukin, Executive Vice President, Deputy General Counsel, Primerica (Aug. 7, 2018) ("Primerica Letter"); Transamerica August 2018 Letter; IPA Letter; Cetera August 2018 Letter.

50 *See, e.g.*, Letter from Felice R. Foundos, Partner, Chapman and Cutler (Aug. 6, 2018) ("Chapman Letter"); Vanguard Letter; ICI Letter; Morgan Stanley Letter; Wells Fargo Letter; Primerica Letter; Great-West Letter; NASAA August 2018 Letter; Cambridge Letter; Blackrock Letter.

recommendation and suggested clarifying the scope of the inquiry into potential reasonably available alternatives when a broker-dealer offers a limited product menu versus when the broker-dealer has an "open architecture" model.[51] Several industry commenters made recommendations regarding the application of proposed Regulation Best Interest to recommendations of specific categories of securities, such as variable annuities or leveraged exchange-traded products.[52]

With respect to the Conflict of Interest Obligation, many commenters questioned the distinction between financial incentives that would have to be mitigated and other conflicts that would only need to be disclosed, and recommended generally that the distinction be eliminated.[53] In addition, some commenters suggested that the obligation to establish policies

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51 *See, e.g.*, IAC 2018 Recommendation; Fidelity Letter; ICI Letter; SIFMA August 2018 Letter; Prudential Letter; LPL August 2018 Letter; Morningstar Letter. *See also* AFL-CIO April 2019 Letter (stating that the rule "must make clear that brokers are required to recommend the investments they reasonably believe are the best match for the investor from among the reasonably available investment options").

52 *See, e.g.*, Letter from Brian Winikoff, Senior Executive Director and Head of U.S. Life, Retirement and Wealth Management, AXA (Aug. 7, 2018) ("AXA Letter"); Letter from Clifford Kirsch, Susan Krawczyk, Eversheds Sutherland, Committee of Annuity Insurers (Aug. 7, 2018) ("Committee of Annuity Insurers Letter"); Pacific Life August 2018 Letter; Letter from Angela Brickl, General Counsel, Rafferty Asset Management ("Direxion") (Aug. 7, 2018) ("Direxion Letter"); Letter from Mark F. Halloran, VP Managing Director, Business Development, Transamerica (Nov. 9, 2018) ("Transamerica November 2018 Letter").

53 *See, e.g.*, CFA August 2018 Letter; SIFMA August 2018 Letter; Primerica Letter; Letter from Jeff Hartney, Executive Director, Bank Insurance and Securities Association

and procedures to mitigate conflicts should apply to material conflicts at the level of the natural person who is an associated person (as opposed to the firm).[54] Commenters also asked for more clarity and examples of what conflicts must be mitigated versus eliminated and more guidance on appropriate mitigation methods.[55] Some commenters also expressed the view that by requiring mitigation of financial incentives, proposed Regulation Best Interest would require more of broker-dealers than what is required of investment advisers under their fiduciary duty, which could create a competitive disadvantage for broker-dealers that could further encourage migration from the broker-dealer to investment adviser business model and result in a loss of retail investor access (in terms of choice and cost) to differing types of investment services and products.[56]

("BISA") (Aug. 7, 2018) ("BISA Letter"); Committee of Annuity Insurers Letter; IPA Letter; CFA Institute Letter; Morgan Stanley Letter; CCMC Letters.

54 *See, e.g.*, Primerica Letter; TIAA Letter; ICI Letter; Letter from Craig D. Pfeiffer, President and CEO, Money Management Institute (Aug. 7, 2018) ("Money Management Institute Letter").

55 *See, e.g.*, AALU Letter; CFA August 2018 Letter; Letter from Quinn Curtis, Professor of Law, University of Virginia School of Law ("UVA"), (Aug. 3, 2018) ("UVA Letter"); Primerica Letter; Committee of Annuity Insurers Letter; Cetera August 2018 Letter; Wells Fargo Letter; NASAA August 2018 Letter; Morningstar Letter.

56 *See, e.g.*, Letter from Craig S. Tyle, Executive Vice President and General Counsel, Franklin Templeton Investments, (Aug. 6, 2018) ("Franklin Templeton Letter"); Primerica Letter; LPL August 2018 Letter; CCMC Letters; UBS Letter; ICI Letter; Letter from Christopher A. Iacovella, Chief Executive Officer, American Securities Association ("ASA") (Aug. 7, 2018) ("ASA Letter"); Schwab Letter.

In addition, a number of commenters agreed with the Commission's statement that it was not intended to create a private right of action, but many requested that the Commission explicitly state in the final rule that Regulation Best Interest does not confer a private right of action.[57] One commenter requested that the Commission elaborate and make clear the remedies available to investors when broker-dealers violate Regulation Best Interest and emphasize that scienter is not required to establish a violation of Regulation Best Interest.[58]

Finally, numerous commenters urged the Commission to coordinate with other regulators, in particular the DOL[59] and state securities and insurance regulators,[60] and several commenters opined that the Commission should preempt (or avoid preempting) state law.[61]

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57 *See, e.g.,* Letter from Paul C. Reilly, Chairman and CEO, Raymond James Financial (Aug. 7, 2018) ("Raymond James Letter"); NAIFA Letter; ASA Letter; CCMC Letters; UBS Letter; LPL August 2018 Letter; Cambridge Letter. *Contra* Letter from Elise Sanguinetti, President, American Association for Justice (Aug. 6, 2018) ("American Association for Justice Letter").

58 NASAA August 2018 Letter.

59 *See, e.g*., ICI Letter; Franklin Templeton Letter; Morningstar Letter; Wells Fargo Letter; Edward Jones Letter; IRI Letter; Letter from Cynthia Lo Bessette, Executive Vice President and General Counsel, Letter from Oppenheimer Funds (Aug. 7, 2018) ("Oppenheimer Letter"); Vanguard Letter.

60 *See, e.g.,* CCMC Letters; Letter from Robert Reynolds, President and CEO, Putnam Investments (Aug. 7, 2018) ("Putnam Letter"); Letter from Will H. Fuller, Executive Vice President, President, Annuity Solutions, Lincoln Financial Group (Nov. 13, 2018) ("Lincoln Financial Letter"); Cetera August 2018 Letter; Great-West Letter; Letter from Marc Cadin, Chief Operating Officer, Association of Advanced Life Underwriting ("AALU") (Aug. 7, 2018) ("AALU Letter"); IRI Letter; Pacific Life August 2018 Letter; Vanguard Letter; Fidelity Letter; Letter from Andrew J. Bowden, Senior Vice President and General Counsel, Jackson National Life Insurance Company (Aug. 7, 2018)

After carefully reviewing the comments on the proposed rule, we have determined to retain its overall structure and scope. However, we have modified the proposed rule in a number of respects and are also providing additional interpretations and guidance to address and clarify issues raised by commenters. Summarized below are the key modifications from the proposal, as well as the interpretations and guidance provided.

- *Retail Customer Definition*: We are modifying the definition of "retail customer" to include *any natural person* who receives a recommendation from the broker-dealer for the natural person's own account (but not an account for a business that he or she works for), including individual plan participants.[62] We are interpreting "legal

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("Jackson National Letter"); Invesco Letter; Lincoln Letter; CUNA Mutual Letter; Great-West Letter.

61 *See, e.g.,* Cetera August 2018 Letter; ICI Letter; Franklin Templeton Letter; Putnam Investments Letter; *but see* NASAA August 2018 Letter; PIABA Letter; Letter from Teresa J. Verges, Director, Investor Rights Clinic, University of Miami School of Law (Aug. 2, 2018) ("U. of Miami Letter"); Letter from Kayla Martin, Legal Intern, Christine Lazaro, Director and Professor Clinical Legal Education, Securities Arbitration Clinic, St. John's University School of Law (Aug. 7, 2018) ("St. John's U. Letter"); Letter from Kevin M. Carroll, Managing Director & Associate General Counsel, SIFMA (Mar. 29, 2019) ("SIFMA March 2019 Letter"); Letter from Michael Pieciak, NASAA President and Commissioner, Vermont Department of Regulation, NASAA (Apr. 25, 2019); Letter from Tom Quaadman, Executive Vice President, CCMC (May 16, 2019) ("CCMC May 2019 Letter"); AFL-CIO April 2019 Letter.

62 As discussed in Section II.B.3.a, Retail Customer, Focus on Natural Persons and Legal Representatives of Natural Persons, to the extent a plan representative who decides service arrangements for a workplace retirement plan is a sole proprietor or other self-employed individual who will participate in the plan, the plan representative will be a retail customer to the extent that the sole proprietor or self-employed individual receives

representative of such natural person" to include the nonprofessional legal representatives of such a natural person (e.g., nonprofessional trustee who represents the assets of a natural person).

- *Implicit Hold Recommendations*: While broker-dealers will not be required to monitor accounts, in instances where a broker-dealer agrees to provide the retail customer with specified account monitoring services, it is our view that such an agreement will result in buy, sell or hold recommendations subject to Regulation Best Interest, even when the recommendation to hold is implicit.[63]
- *Recommendations of account types, including recommendations to roll over or transfer assets from one type of account to another*: We are modifying Regulation Best Interest to expressly apply to account recommendations including, among others, recommendations to roll over or transfer assets in a workplace retirement plan account to an IRA, recommendations to open a particular securities account (such as brokerage or advisory), and recommendations to take a plan distribution for the purpose of opening a securities account.[64] We are also providing guidance under the

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recommendations directly from a broker-dealer primarily for personal, family or household purposes.

63 *See* Section II.B.2.b, Interpretation of Any Securities Transaction or Investment Strategy Involving Securities.

64 *See id*.

Care Obligation on what factors a broker-dealer generally should consider when making such recommendations.

- *Dual-Registrants:* We are providing additional guidance on how dual-registrants can comply with Regulation Best Interest, and confirming that Regulation Best Interest does not apply to advice provided by a broker-dealer that is dually registered as an investment adviser ("dual-registrant") when acting in the capacity of an investment adviser, and that a dual-registrant is an investment adviser solely with respect to accounts for which a dual-registrant provides advice and receives compensation that subjects it to the Advisers Act.[65]

We are also clarifying the relationship between the General Obligation and the specific component obligations, and in particular, what it means to "act in the best interest" of the retail customer. As is the case with the fiduciary duty applicable to investment advisers under the Advisers Act, we are not expressly defining in the rule text the term "best interest," and instead are providing in Regulation Best Interest and through interpretations, what "acting in the best interest" means.[66] Whether a broker-dealer has acted in the retail customer's best interest in compliance with Regulation Best Interest will turn on an objective assessment of the facts and

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65 *See* Section II.B.3.d, Retail Customers, Treatment of Dual-Registrants.

66 In the investment adviser context, an investment adviser's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty. This combination of care and loyalty obligations has been characterized as requiring the investment adviser to act in the "best interest" of its client at all times. *See* Fiduciary Interpretation.

circumstances of how the specific components of Regulation Best Interest—including its Disclosure, Care, Conflict of Interest, and Compliance Obligations—are satisfied at the time that the recommendation is made (and not in hindsight). In response to commenters, we are addressing, among other things, what the General Obligation does and does not require (for example, that it does not impose a continuing duty beyond a particular recommendation), providing specific examples of what would violate Regulation Best Interest, and its application to certain scenarios, particularly in the context of satisfying the Care Obligation.

We are also modifying and clarifying the component obligations that a broker-dealer would be required to satisfy in order to meet the General Obligation:

Disclosure Obligation. We are refining the treatment of conflicts of interest by: (1) defining in the rule text a "conflict of interest" for purposes of Regulation Best Interest (as opposed to interpreting the phrase "material conflict of interest" as in the Proposing Release) as an interest that might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested; and (2) revising the Disclosure Obligation to require disclosure of "material facts" regarding conflicts of interest associated with the recommendation.[67] Similar to the proposal, all such conflicts of interest will be covered by Regulation Best Interest (e.g., subject to the Conflict of Interest Obligation), however, only

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[67] *See* Section II.C.1.b, Disclosure Obligation, Material Facts Regarding Conflicts of Interest.

"material facts" regarding these conflicts would be required to be disclosed under the Disclosure Obligation.

Furthermore, we are modifying the Disclosure Obligation to explicitly require broker-dealers to provide "full and fair" disclosure of material facts, rather than requiring broker-dealers to "reasonably disclose" such information. We are providing the Commission's view regarding what it means to provide "full and fair" disclosure to retail customers, including the level of specificity of disclosure required, and the form and manner and timing and frequency of such disclosure.[68] We are explicitly requiring the disclosure of material facts relating to the scope and terms of the relationship that were specifically identified in the proposal (i.e., capacity, material fees and charges, and type and scope of services).[69] In connection with disclosure requirements regarding the type and scope of services, we are also clarifying that at a minimum, a broker-dealer needs to disclose whether or not account monitoring services will be provided (and if so, the scope and frequency of those services), account minimums, and any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer.[70] Also we conclude that the basis for a broker-dealer's recommendations as a general matter (i.e., what might commonly be described as the firm's investment approach, philosophy,

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68 *See* Section II.C.1.c, Disclosure Obligation, Full and Fair Disclosure.

69 *See* Section II.C.1.a, Disclosure Obligation, Material Facts Regarding Scope and Terms of the Relationship.

70 *Id.*

or strategy) and the risks associated with a broker-dealer's recommendations in standardized (as opposed to individualized) terms are material facts relating to the scope and terms of the relationship that should be disclosed.[71] Below, we outline a method to address oral disclosure and written disclosure provided after the fact.[72]

Care Obligation. We are adopting the Care Obligation largely as proposed; however, we are expressly requiring that a broker-dealer understand and consider the potential *costs* associated with its recommendation, and have a reasonable basis to believe that the recommendation does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer.[73] Nevertheless, we emphasize that while cost must be considered, it should never be the only consideration. Cost is only one of many important factors to be considered regarding the recommendation and that the standard does not necessarily require the "lowest cost option." Relatedly, we are emphasizing the need to consider costs in light of other factors and the retail customer's investment profile.

We are also providing additional guidance on what it means to make a recommendation in a retail customer's "best interest." As in the Proposing Release, determining whether a broker-dealer's recommendation satisfies the Care Obligation will be an objective evaluation

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71 *Id.*

72 *See* Section II.C.1, Disclosure Obligation, Oral Disclosure or Disclosure After a Recommendation.

73 *See generally* Section II.C.2, Care Obligation.

turning on the facts and circumstances of the particular recommendation and the particular retail customer. We recognize that a facts and circumstances evaluation of a recommendation makes it difficult to draw bright lines around whether a particular recommendation will meet the Care Obligation. Accordingly, we focus on how a broker-dealer could establish a reasonable basis to believe that a recommendation is in the best interest of its retail customer and does not place the broker-dealer's interest ahead of the retail customer's interest, and the circumstances under which a broker-dealer could not establish such a reasonable belief.

We are clarifying that an evaluation of reasonably available alternatives does not require an evaluation of every possible alternative (including those offered outside the firm) nor require broker-dealers to recommend one "best" product, and what this evaluation will require in certain contexts (such as a firm with open architecture). Furthermore, we clarify that, when a broker-dealer materially limits its product offerings to certain proprietary or other limited menus of products, it must still comply with the Care Obligation—even if it has disclosed and taken steps to prevent the limitation from placing the interests of the broker-dealer ahead of the retail customer, as required by the Disclosure and Conflict of Interest Obligation—and thus could not use its limited menu to justify recommending a product that does not satisfy the obligation to act in a retail customer's best interest.

Conflict of Interest Obligation. We are revising the Conflict of Interest Obligation by: (1) similar to the proposal, establishing an overarching obligation to establish written policies

and procedures to identify and at a minimum disclose (pursuant to the Disclosure Obligation), or eliminate, all conflicts of interest associated with the recommendation;[74] and (2) setting forth explicit requirements to establish written policies and procedures reasonably designed to mitigate or eliminate certain identified conflicts of interest, specifically:

- *Mitigation of Associated Person Conflicts of Interest*. We are revising the proposal's mitigation requirement to: (1) eliminate the distinction between financial incentives and all other conflicts of interest; and (2) focus on mitigating conflicts of interest associated with recommendations that create an incentive for the associated person of the broker-dealer to place the interest of the firm or the associated person ahead of the interest of the retail customer.[75] We are providing further guidance regarding the types of incentives covered by this revised obligation, in particular focusing on compensation or employment related incentives and other incentives provided to the associated person (whether by the broker-dealer or third-parties). We are also confirming, clarifying and expanding on the

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74 This obligation achieves greater consistency with the treatment of conflicts under the Advisers Act. As discussed in the Fiduciary Interpretation, in seeking to meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship. An adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser —consciously or unconsciously—to render advice which was not disinterested. *See* Fiduciary Interpretation.

75 *See generally* Section II.C.3.e, Conflict of Interest Obligation, Mitigation of Certain Incentives to Associated Persons.

proposal's guidance on potential mitigation methods to further promote compliance with this obligation.

- *Address Any Material Limitations on Recommendations to Retail Customers*. To address the conflicts of interest presented when broker-dealers place any material limitations on the securities or investment strategies involving securities that may be recommended to a retail customer (i.e., only make recommendations of proprietary or other limited range of products), we are requiring broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to: (1) identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended and any associated conflicts of interest; and (2) prevent the limitations and associated conflicts of interest from causing the broker-dealer or their associated persons to make recommendations that place the interest of the broker-dealer or associated person ahead of the interest of the retail customer (for example, a broker-dealer could establish product review processes or establish procedures addressing which retail customers would qualify for the product menu).[76]
- *Elimination of Certain Conflicts.* We are requiring broker-dealers to establish written policies and procedures reasonably designed to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific

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[76] *See generally* Section II.C.3.f, Conflict of Interest Obligation, Mitigation of Material Limitations on Recommendations to Retail Customers.

securities or the sale of specific types of securities within a limited period of time.[77] By explicitly focusing on policies and procedures to eliminate these incentives, it does not mean that all other incentives are presumptively compliant with Regulation Best Interest. Rather, such other incentives and practices that are not explicitly prohibited are permitted provided that the broker-dealer establishes reasonably designed policies and procedures to disclose and mitigate the incentive created to the representative, and the broker-dealer and its associated persons comply with the Care Obligation and the Disclosure Obligation.

General Compliance Obligation. We are establishing a new, general "Compliance Obligation" to require broker-dealers to establish policies and procedures to achieve compliance with Regulation Best Interest in its entirety.[78]

Books and Records. In addition to adopting Regulation Best Interest, we are also adopting the record-making and recordkeeping requirements largely as proposed, with certain explanations and clarifications regarding the scope of these requirements and the extent to which new obligations have been created.[79]

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77 *See generally* Section II.C.3.g, Conflict of Interest Obligation, Elimination of Certain Conflicts of Interest.

78 *See generally* Section II.C.4, Compliance Obligation.

79 *See generally* Section II.D, Record-Making and Recordkeeping.

Interaction with Other Standards, Waivers and Private Right of Action. Compliance with Regulation Best Interest will 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.[80]

Scienter will not be required to establish a violation of Regulation Best Interest. We note that the preemptive effect of Regulation Best Interest on any state law governing the relationship between regulated entities and their customers would be determined in future judicial proceedings based on the specific language and effect of that state law. We believe that Regulation Best Interest, Form CRS, and the related rules, interpretations and guidance that the Commission is concurrently issuing will serve as focal points for promoting clarity, establishing greater consistency in the level of retail customer protections provided, and easing compliance across the regulatory landscape and the spectrum of investment professionals and products.

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[80] 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.

In addition, under Section 29(a) of the Exchange Act, a broker-dealer will not be able to waive compliance with Regulation Best Interest, nor can a retail customer agree to waive her protections under Regulation Best Interest.

Furthermore, we do not believe Regulation Best Interest creates any new private right of action or right of rescission, nor do we intend such a result.

D. Overview of Key Enhancements

With these modifications and clarifications, Regulation Best Interest is designed to improve investor protection by:

- requiring broker-dealers to have a reasonable basis to believe that recommendations are in the retail customer's best interest, which enhances existing suitability obligations by: requiring compliance not only with the explicit Care Obligation, but also with Disclosure, Conflict of Interest, and Compliance Obligations; expressly requiring consideration of cost in evaluating a recommendation as part of the Care Obligation; expressing our views regarding the consideration of reasonably available alternatives when making a recommendation as part of the Care Obligation; applying Regulation Best Interest to recommendations of account types and rollovers and to any recommendations resulting from agreed-upon account monitoring services (including implicit hold recommendations); and, applying the Care Obligation to a series of recommended transactions (currently referred to as "quantitative suitability") irrespective of whether a broker-dealer exercises actual or *de facto* control over a customer's account;
- requiring broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to mitigate (and in some cases, eliminate) certain identified conflicts of interest that create incentives to make recommendations that are

not in the retail customer's best interest; these new requirements are a significant and critical enhancement as existing requirements under the federal securities laws largely center upon conflict disclosure rather than conflict mitigation;

- requiring disclosure under the Disclosure Obligation of the material facts relating to the scope of terms of a broker-dealer's relationship with the retail customer and the conflicts of interest associated with a broker-dealer's recommendations, which will foster retail customers' understanding of their relationship with the broker-dealer and help them to evaluate the recommendations received; and
- requiring broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Regulation as a whole, which will further promote broker-dealer compliance with Regulation Best Interest.

Through these new requirements, we believe that Regulation Best Interest will improve investor protection by enhancing the quality of broker-dealer recommendations to retail customers and reducing the potential harm to retail customers that may be caused by conflicted brokerage recommendations. We also believe Regulation Best Interest achieves these enhancements in a manner that is workable for the transaction-based relationship offered by broker-dealers, thus preserving, to the extent possible, retail investor access (in terms of choice and cost) to different types of quality investment services and products. As discussed above, Regulation Best Interest will complement Form CRS and related rules, interpretations, and guidance that the Commission is concurrently issuing.

II. DISCUSSION OF REGULATION BEST INTEREST

A. General Obligation

As in the Proposing Release, Regulation Best Interest is set forth in two subparagraphs: (1) an overarching provision setting forth a general best interest obligation ("General Obligation"); and (2) a second provision requiring compliance with specific obligations in order to satisfy the overarching standard (discussed below in Section II.C).[81] Specifically, as in the Proposing Release, the General Obligation requires that a broker-dealer "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]…ahead of the interest of the retail customer."[82]

Most commenters, including a majority of the IAC, expressed opinions on this approach, and in particular on the General Obligation, including whether the obligation should be a "fiduciary" standard, whether it should be a uniform standard for broker-dealers and investment advisers,[83] and whether the standard should be more principles-based or more prescriptive (in particular, whether to define "best interest").[84]

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81 *See* Proposing Release at 21585 *et seq*.

82 *See* Paragraph (a)(1) of Regulation Best Interest.

83 *See* IAC 2018 Recommendation; Letter from Rob Foregger, Co-Founder, NextCapital (Aug. 7, 2018) ("NextCapital Letter") (recommending that the Commission adopt a uniform fiduciary standard of conduct applicable to both broker-dealers and investment advisers); Letter from Sharon Cheever, Senior Vice President and General Counsel, Pacific Life Insurance Company (May 28, 2019) ("Pacific Life May 2019 Letter")

The views of commenters on the approach to an enhanced standard of conduct for broker-dealers varied widely. A number of commenters supported a broker-dealer specific standard of conduct.[85] Several of these commenters supported the Commission's approach as proposed, with certain modifications to the specific component obligations discussed below.[86] Some commenters urged the Commission to change the standard from what the commenters called "suitability-plus" to what the commenters called a "true best interest standard," including the

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(recommending that the Commission adopt a single 'best interest' standard of care for all financial professionals).

See also Letter from R. Scott Henderson, Bank of America (Aug. 7, 2018) ("Bank of America Letter"); Letter from Christopher Jones, Chief Investment Officer, Financial Engines (Aug. 6, 2018) ("Financial Engines Letter"); State Attorneys General Letter; Letter from Jill I. Gross, Associate Dean, Academic Affairs, Elisabeth Haub School of Law, Pace University (Mar. 11, 2019) ("Gross Letter"). Relatedly, one commenter expressed concern that a court or arbitration panel would determine that Regulation Best Interest would control, rather than existing case law, which would apply a fiduciary duty in certain circumstances. *See* Gross Letter. *See also* AFL-CIO April 2019 Letter.

84 *See, e.g.,* Ameriprise Letter; Cambridge Letter; CCMC Letters; Edward Jones Letter; NAIFA Letter; Morningstar Letter; NY Life Letter; Letter from Kevin T. Reynolds, Senior Vice President, Penn Mutual Life Insurance Company (Aug. 1, 2018) ("Penn Mutual Letter"); SIFMA August 2018 Letter; Vanguard Letter; Letter from Kent. A Mason, Davis & Harman LLP (Jul. 20, 2018) ("Davis Harman Letter").

85 *See, e.g.,* SIFMA August 2018 Letter; Cetera August 2018 Letter; Vanguard Letter; Edward Jones Letter; Ameriprise Letter; NY Life Letter; NAIFA Letter; CCMC Letters; Penn Mutual Letter; Cambridge Letter; PIABA Letter; Letter from Ronald J. Kruszewski, Chairman and Chief Executive Officer, Stifel Financial (Aug. 7, 2018) ("Stifel Letter"); Financial Engines Letter.

86 *See, e.g.,* SIFMA August 2018 Letter; Vanguard Letter; Edward Jones Letter; Ameriprise Letter; NY Life Letter; NAIFA Letter; CCMC Letters; Penn Mutual Letter; Cambridge Letter; PIABA Letter.

avoidance of certain conflicts,[87] and urged the Commission to change the name of Regulation Best Interest unless it required firms to always be responsible for acting in the retail customer's best interest (as opposed to at the time of the recommendation).[88] Other commenters advocated for the adoption of a broker-dealer standard modeled after FINRA suitability rules,[89] and some suggested that the Commission create a safe harbor from liability for compliance with Regulation Best Interest.[90]

By contrast, other commenters recommended that the Commission adopt a uniform standard of conduct for investment advisers and broker-dealers, in varying forms.[91] Commenters expressed differing views on the form of such a uniform standard of conduct, including that the Commission should adopt: a fiduciary standard for broker-dealers similar to, or no less stringent than, the fiduciary duty under the Advisers Act;[92] a uniform fiduciary standard as articulated in

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87 *See, e.g.*, CFA Institute Letter.

88 *See, e.g.*, Letter from Jean-Luc Bourdon, CPA/PFS, Chair, Personal Financial Planning Legislative and Regulatory Task Force, and Charles R. Kowal, Chair, Personal Financial Planning Executive Committee, AICPA (Aug. 7, 2018) ("AICPA Letter"); Betterment August 2018 Letter; NASAA August 2018 Letter.

89 *See, e.g.*, National Society of Compliance Professionals Letter; Cetera August 2018 Letter.

90 *See* Cambridge Letter; BISA Letter; IPA Letter.

91 *See, e.g.*, Betterment Letter; AARP August 2018 Letter; AFR Letter; Galvin Letter; State Attorneys General Letter.

92 *See, e.g.*, Betterment Letter; Warren Letter; Fein Letter; Letter from Joseph M. Torsella, Pennsylvania State Treasurer, et al. (Aug. 7, 2018) ("State Treasurers Letter"); AARP August 2018 Letter.

Section 913(g) of the Dodd-Frank Act[93] and/or consistent with the recommendations of the staff's Section 913 Study;[94] or a uniform standard similar to the DOL standard as reflected in the BIC Exemption;[95] harmonized requirements and guidance for broker-dealers and investment advisers offering services to retail customers;[96] or a new uniform best interest standard, with common core elements.[97]

In this vein, a number of commenters suggested specific revisions to the text of the General Obligation to clarify what the standard requires with respect to broker-dealer conflicts of interest, including that the Commission change the proposed "without placing the financial or other interest [of the broker-dealer] ahead" language to a standard that requires a recommendation be made "without regard to" a broker-dealer's interest[98] and/or requires the broker-dealer to "place the customer's interest first" or ahead of its own.[99] These commenters stated that changing the proposed language to a "without regard to" and/or "place the customer's

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93 *See, e.g.*, FPC Letter; Letter from Maxine Waters, Ranking Member, Committee on Financial Services, U.S. House of Representatives, et al. (Sep. 12, 2018) ("Waters Letter"); Fein Letter.

94 *See, e.g.*, ACLI Letter; Schwab Letter.

95 *See, e.g.*, Galvin Letter. *See supra* footnote 32.

96 *See, e.g.*, AARP August 2018 Letter.

97 *See, e.g.*, Pacific Life August 2018 Letter.

98 *See, e.g.*, CFA August 2018 Letter; FPC Letter; PACE Letter; Better Markets August 2018 Letter.

99 *See, e.g.*, Invesco Letter; Schwab Letter; Better Markets August 2018 Letter; CFA Institute Letter.

interest first" phrasing would result in a stronger standard, whereas the proposed phrasing would allow a broker-dealer to act in its own interests as long as the broker-dealer does not put its interests ahead of its customers' interest.[100] These commenters stated that broker-dealers must put aside their own interest when determining what is best for the retail customer, that broker-dealers must ensure that conflicts do not taint recommendations.[101]

Some commenters challenged the Commission's concern that the "without regard to" language "could be inappropriately construed to require a broker-dealer to eliminate all of its conflicts," arguing that their position is supported by the plain meaning of the language and the context of 913(g) (which explicitly recognizes conflicts in certain areas), and the interpretations by others (such as the DOL) who have used it.[102] Highlighting what commenters viewed as inconsistencies in the Proposing Release's interpretation of the proposed "without placing . . . ahead" phrasing, such as statements that the obligation would require broker-dealers to "put aside their interests" when making a recommendation versus others suggesting that a broker-dealer's interests cannot "predominantly motivate" or be the "sole basis" for the recommendation, some commenters suggested we either adopt the "without regard to" phrasing

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100 *See, e.g.*, CFA August 2018 Letter; FPC Letter; Pace Letter.

101 *See, e.g.*, CFA August 2018 Letter.

102 *See, e.g.*, CFA August 2018 Letter; Waters Letter.

or state that the proposed phrasing requires a broker-dealer to put aside its interests.[103] Some commenters further stated that the "without regard to" phrasing, which is used in Section 913(g) of the Dodd-Frank Act, is the stronger standard of conduct that Congress intended, and challenged the Commission's reliance on the authority provided in Section 913(f).[104] In this vein, some commenters suggested that the Commission should adopt a uniform standard of conduct for broker-dealers and investment advisers that was authorized under Section 913(g), and recommended by the staff in the Section 913 Study.[105]

Other commenters, however, supported the proposal's "without placing…ahead" formulation.[106] These commenters expressed concern that a "without regard to" standard would require "conflict free" recommendations, which would limit compensation structures and the offering of certain products.[107] Instead, commenters stated that the appropriate role of a best interest standard is to require disclosure and management of conflicts of interest.[108] Others

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103 *See, e.g.,* CFA August 2018 Letter. *See also* Waters Letter (stating that the proposal fails to adequately explain just what it would require of brokers that is different from the status quo, that the standard should clearly differ from the current "suitability" standard, and that any final rule must clearly explain the standard, what it requires and prohibits, and how it differs from the status quo).

104 *See, e.g.*, CFA August 2018 Letter; State Attorneys General Letter; Waters Letter.; FPC Letter; Better Markets August 2018 Letter.

105 *See, e.g.,* Waters Letter; FPC Letter.

106 *See, e.g.,* AALU Letter; Cetera August 2018 Letter; NAIFA Letter; Pickard Letter.

107 *See, e.g.*, AALU Letter; Cetera August 2018 Letter; NAIFA Letter; Pickard Letter.

108 *See, e.g.*, AALU Letter; Cetera August 2018 Letter.

generally supported, or did not object to, the Commission's decision not to proceed under its 913(g) authority in its current proposal.[109]

A common theme across many comments was the need for additional guidance on what "best interest" means, with some commenters recommending that the Commission codify its interpretation of "best interest" or provide a more specific definition of what it means to act in the "best interest."[110] Several commenters suggested that the "best interest" standard should require the "best" or most beneficial product available,[111] while others (including a majority of the IAC) requested that the Commission clarify that there is no single "best" recommendation and that the obligation is to adhere to a professional standard of conduct when making a

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109 *See, e.g.,* Invesco Letter; IAC 2018 Recommendation (stating "we recognize that the Commission has chosen not to proceed under its 913(g) authority in its current proposal, and it is not our intent to derail that proposal by advocating that the Commission change the legal basis for its rulemaking. Moreover, we believe the clarifications we have outlined above to the meaning of best interest, if implemented, have the potential to deliver immediate benefits to customers of broker-dealers and investment advisers alike. Should the Commission determine, however, that it cannot enforce the clarified best interest standard under the Advisers Act, a majority of the Committee believes the Commission should reconsider rulemaking under its 913(g) authority to close that regulatory gap."). As noted above, Regulation Best Interest draws from key principles underlying fiduciary obligations, including those that apply to investment advisers under Advisers Act. Accordingly, as discussed below, the Commission has chosen to enhance existing obligations for broker-dealers when they make recommendations to a retail customer, while, in a separate interpretation, reaffirming and in some cases clarifying an investment adviser's fiduciary duty. *See* Fiduciary Interpretation.

110 *See, e.g.*, NASAA August 2018 Letter.

111 *See, e.g.*, Financial Engines Letter; CFA August 2018 Letter.

recommendation.[112] Some commenters suggested defining "best interest" as including a duty of loyalty and care.[113] Several also suggested that the Commission incorporate best execution and fair pricing and compensation as factors for determining compliance with the standard.[114]

Several commenters recommended that the Commission adopt a definition of best interest that is consistent with the best interest obligation described by the DOL in the BIC Exemption's Impartial Conduct Standards,[115] and supported a standard which would require a broker-dealer to act "solely" in the interest of the retail customer when making a recommendation.[116] Conversely, other commenters recommended that the "best interest" standard could be satisfied even if the recommendations are in part influenced by "self-promotion."[117]

Finally, in lieu of a prescribed definition of "best interest," a number of commenters advocated for a facts-and-circumstances or "totality of the circumstances approach" for

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112 *See, e.g.*, Wells Fargo Letter; *see also* IAC 2018 Recommendation ("[T]he Commission should recognize there will often not be a single best option and that more than one of the available options may satisfy this standard.").

113 *See, e.g*., TIAA Letter; Morningstar Letter.

114 *See, e.g.*, CFA Institute Letter; Letter from Mark Heckert, Vice President, Pricing and Analytics, ICE Data Services, (Aug. 7, 2018) ("ICE Letter"); FPC Letter.

115 *See, e.g.*, AARP August 2018 Letter; Wells Fargo Letter; Schwab Letter; NASAA August 2018 Letter.

116 *See, e.g.*, Galvin Letter.

117 See, e.g., LPL August 2018 Letter.

determining compliance with the "best interest" standard.[118] A majority of the IAC recommended that the meaning of the best interest obligation should be clarified to require "broker-dealers, investment advisers, and their associated persons to recommend the investments, investment strategies, accounts or services, from among those they have reasonably available to recommend, that they reasonably believe represent the best available options for the investor."[119]

After careful consideration of these comments, we continue to believe that our proposed approach for enhancing the standards of conduct that apply to broker-dealers' recommendations to retail customers is the appropriate approach, and therefore we are adopting as proposed the structure and scope of Regulation Best Interest, including the phrasing of the General Obligation, and are not expressly defining "best interest" in the rule text.[120] However, in consideration of these comments, we are providing our views on what the standard generally requires, what it is intended to achieve, and its alignment in many respects with fiduciary principles.

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118 *See, e.g.*, AAJ Letter; CFA August 2018 Letter.

119 IAC 2018 Recommendation.

120 Another commenter stated that any modification to the proposed rules and guidance that would make them "more restrictive" should be reproposed for additional public comment. *See* ACLI Letter. Because we have provided notice and the changes we are making are based on comments we received, reproposal is not necessary.

1. Commission's Approach

After extensive consideration, and for the reasons discussed in the Proposing Release and further below, we are adopting a rule to enhance the existing broker-dealer conduct obligations when they make recommendations to a retail customer.[121] At the same time, we seek to preserve retail investor access (in terms of choice and cost) to differing types of investment services and products.

The Commission is adopting Regulation Best Interest pursuant to the express and broad grant of rulemaking authority in Section 913(f) of the Dodd-Frank Act.[122] As some commenters noted, Section 913(g) expressly authorizes the Commission to adopt rules that would hold broker-dealers to the same standard of conduct as investment advisers. However, the availability

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121 *See* Proposing Release at 21575. In particular, we considered the recommendations made by our staff in 2011 and the recommendations of the IAC. *See* 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; Recommendation of the Investor Advisory Committee: Broker-Dealer Fiduciary Duty (Nov. 2013) ("IAC 2013 Recommendation"), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation-2013.pdf; IAC 2018 Recommendation.

122 Section 913(f) of the Dodd-Frank Act 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 addition to Section 913(f), the Commission is promulgating Regulation Best Interest pursuant to other provisions of the Exchange Act, including Section 15(c)(6) and Section 17.

of overlapping, yet distinct, rulemaking power under Section 913(g) does not negate the grant of authority under Section 913(f). The plain text of Section 913(f) authorizes the Commission to promulgate this rule addressing the legal and regulatory standards of care for broker-dealers, and their associated persons.

The Commission is utilizing its authority under 913(f) in order to adopt an enhanced investor-protection standard for broker-dealers that maintains the availability of both the broker-dealer model and the investment adviser model. The Commission has chosen not to apply the existing fiduciary standard under the Advisers Act to broker-dealers in part because of concerns that such a shift would result in fewer broker-dealers offering transaction-based services to retail customers, which would in turn reduce choice and may raise costs for certain retail customers.

Moreover, the Commission has chosen not to create a new uniform standard applicable to both broker-dealers and investment advisers which, among other things, would discard decades of regulatory and judicial precedent and experience with the fiduciary duty for investment advisers that has generally worked well for retail clients and our markets. We believe that adopting a "one size fits all" approach would not appropriately reflect the fact that broker-dealers and investment advisers play distinct roles in providing recommendations or advice and services to investors, and may ultimately harm retail investors. Instead, the Commission has chosen to enhance existing obligations for broker-dealers when they make recommendations to a retail

customer, while, in a separate interpretation, reaffirming and in some cases clarifying an investment adviser's fiduciary duty.[123]

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[123] Although we are not adopting a uniform fiduciary standard of conduct, we note that our rules are designed to achieve many of the key goals advocated for by supporters of a uniform standard of conduct. For example, in advocating for a uniform standard of conduct former Commission Chair Elisse B. Walter (then a Commissioner) stated that (1) "[t]o appreciate fully what a fiduciary standard means, and what it really means to act in the best interest of an investor, it is absolutely necessary to drill down and determine what duties and obligations flow from a fiduciary standard," (2) "a fiduciary standard is not a substitute for business practice rules…[r]ather, the two are complementary…and can be used by the Commission] to prohibit certain conflicted behavior or to require mitigation or management of the conflict," (3) "what a fiduciary duty requires depends on the scope of the engagement," and (4) "[m]ost important, whatever gloss and guidance the Commission provides, it should not deviate from the basic principle that financial professionals should always act in the best interests of investors, both large and small." Commissioner Elisse B. Walter, Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization? (May 5, 2009), *available at* https://www.sec.gov/news/speech/2009/spch050509ebw.htm.

In our Fiduciary Interpretation and in this release, we are providing our views on the duties and obligations that flow from the fiduciary duty and Regulation Best Interest. In this release, we discuss the specific obligations of broker-dealers under the Disclosure, Care and Conflicts of Interest Obligations, which include requirements to establish policies and procedures that comply with the Conflict of Interest Obligation, specifically to disclose and mitigate (*i.e.*, reasonably reduce), or eliminate, certain conflicts. As discussed below, these specific obligations are tailored to address particular concerns that arise as a result of the broker-dealer model. For that reason, as well as the other reasons set forth above, the Commission does not believe that it is necessary to adopt a uniform standard in order to ensure that these specific obligations also apply to investment advisers, as the IAC suggests. *See* IAC 2018 Recommendation. In our Fiduciary Interpretation, we state that "the application of the investment adviser's fiduciary duty will vary with the scope of the relationship," and here we have noted that we are not expressly defining in the rule text the term "best interest," and instead are providing in the rule and through interpretations what "best interest" means. Compliance with each of the specific component obligations will turn on an objective assessment of the facts and circumstances of how the specific components of Regulation Best Interest are satisfied at

Regulation Best Interest considers and incorporates (to the extent appropriate) obligations that apply to investment advice in other contexts, with the goal of fostering greater consistency and clarity in the level of protection provided to retail customers at the time that a recommendation is made. We are tailoring these principles to the structure and characteristics of the broker-dealer relationship with retail customers and building upon existing regulatory obligations. As a result, Regulation Best Interest protects investors who seek access to the services, products, and payment options offered by broker-dealers.

Although we are not applying the existing fiduciary standard under the Advisers Act to broker-dealers, key elements of the standard of conduct that applies to broker-dealers under Regulation Best Interest will be substantially similar to key elements of the standard of conduct that applies to investment advisers pursuant to their fiduciary duty under the Advisers Act[124] at the time that a recommendation is made. Regulation Best Interest's regulatory structure is unique to broker-dealers—and is tailored to the broker-dealer business model—but regardless of

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the time that the recommendation is made. Finally, regardless of whether a retail investor chooses a broker-dealer or an investment adviser (or both), the retail investor will be entitled to a recommendation (from a broker-dealer) or advice (from an investment adviser) that is in the best interest of the retail investor and that does not place the interests of the firm or the financial professional ahead of the interests of the retail investor.

[124] Specifically, an investment adviser's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty. This combination of care and loyalty obligations has been characterized as requiring the investment adviser to act in the "best interest" of its client at all times. *See* Fiduciary Interpretation.

whether a retail investor chooses a broker-dealer or an investment adviser (or both), the retail investor will be entitled to a recommendation (from a broker-dealer) or advice (from an investment adviser) that is in the best interest of the retail investor and that does not place the interests of the firm or the financial professional ahead of the interests of the retail investor.

As discussed in the proposal, and in the discussion below, Regulation Best Interest, as adopted, incorporates Care and Conflict of Interest Obligations substantially similar to the fiduciary duties of care and loyalty under Section 206(1) and (2) of the Advisers Act, even if not in the same manner as the 913 Study recommendations or identical to the duties under the Advisers Act.[125] We extensively considered the 913 Study as part of developing Regulation Best Interest, as discussed in the Proposing Release, and believe that the enhancements to the broker-dealer standard of conduct incorporate, and in many aspects (such as the concept of mitigation, and the detailed Care Obligation), build upon and go beyond the recommendations in the 913 Study.

Although key elements are substantially similar, the Commission notes that the obligations of a broker-dealer under Regulation Best Interest and the obligations of an investment adviser pursuant to its fiduciary duty under the Advisers Act differ in certain respects, taking into account the scope of the services and relationships typically offered by broker-dealers and investment advisers. For example, an investment adviser's duty of care

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125 *See* Proposing Release at 21590.

encompasses the duty to provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship. This difference reflects the generally ongoing nature of the advisory relationship, and the Commission's view that, within the scope of the agreed adviser-client relationship, investment advisers' fiduciary duty generally applies to the entire relationship. In contrast, the provision of recommendations in a broker-dealer relationship is generally transactional and episodic, and therefore the final rule requires that broker-dealers act in the best interest of their retail customers at the time a recommendation is made and imposes no duty to monitor a customer's account following a recommendation.

As noted above, Regulation Best Interest also generally imposes more specific obligations on broker-dealers under the Disclosure, Care and Conflict of Interest Obligations (each of which is discussed in detail below) than the principles-based requirements of investment advisers' fiduciary duty under the Advisers Act. This approach is intended to tailor the application of principles that have developed in the context of a different business model over the course of almost 80 years. Moreover, this more specific and tailored approach drawing on key fiduciary principles (1) is consistent with the generally rules-based regulatory regime that applies to broker-dealers, (2) acknowledges that certain relevant obligations may already be addressed by existing broker-dealer requirements (e.g., broker-dealers are already subject to a duty of best execution), (3) allows us to impose requirements that we are believe are more appropriately tailored to address the specific conflicts raised by the transaction-based nature of the broker-dealer model, and (4) recognizes that it would be inappropriate to apply to certain generally applicable obligations of investment advisers (e.g., duty to monitor) in the context of a transaction-based relationship.

These specific obligations include express requirements relating to the Care Obligation, requiring that a broker-dealer exercise reasonable diligence, care, and skill to: (1) understand the risks, rewards and costs of a recommendation; (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 that the recommendation does not place the broker-dealer's interest ahead of the retail customer's interest; and (3) have a reasonable basis to believe that a series of transactions is in the best interest of the retail customer and does not place the interest of the broker-dealer ahead of the retail customer's interests. Regulation Best Interest imposes a duty of care that enhances existing suitability obligations (as discussed further below). It also includes a requirement under the Care Obligation to specifically address the risk that a broker-dealer's transaction-based recommendations and compensation could result in a series of recommendations that are not in the best interest or a retail customer—a "churning" risk unique to the broker-dealer model of providing recommendations and resulting transaction-based compensation.

Regulation Best Interest also includes a requirement under the Conflict of Interest Obligation for broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to (1) mitigate conflicts of interest at the associated person level, (2) specifically address the conflicts of interest presented when broker-dealers place material limitations on the securities or products that may be recommended (i.e., only make recommendations of proprietary or other limited range of products), and (3) eliminate sales contests, 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. The conflicts of interest associated with incentives at the associated person level and limitations on the securities or products that

may be recommended to retail customers have raised particular concerns in the context of the broker-dealer, transaction-based relationship. Accordingly, the Commission believes specific disclosure and additional mitigation requirements are appropriate to address those conflicts. Sales contests, sales quotas, bonuses and non-cash compensation that are based on the sales of specific securities within a limited period of time create high-pressure situations for associated persons to increase the sales of specific securities or specific types of securities within a limited period of time and thus compromise the best interests of their retail customers. The Commission does not believe such conflicts of interest can be reasonably mitigated and, accordingly, they must be eliminated.

Phrasing of Standard

We are adopting the phrasing "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] ahead of the interest of the retail customer" as it was proposed.[126] In response to comments, we are clarifying our views on what this standard entails and how it compares to the "without regard to" language of Section 913.

By replacing the "without regard to" language of Section 913(g) and the 913 Study with the "without placing the financial or other interest of the [broker-dealer] . . . ahead of the interest

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[126] *See* paragraph (a)(1) of Regulation Best Interest. As discussed in Section II.C.2, we are also adding the phrasing "does not place the financial or other interest of the broker, dealer, or such natural person. . . ahead of the retail customer" to certain provisions of the Care Obligation.

of the retail customer" phrasing, we did not intend to create a "lower" or "weaker" standard compared to the language of Section 913(g) and the 913 Study. Rather, we are adopting a standard that reflects that a broker-dealer should not put its interests ahead of the retail customer's interest, and thereby aligns with (and in certain areas imposes more specific obligations than) the investment adviser fiduciary duty, at the time a broker-dealer makes a recommendation to a retail customer.

As discussed in the Proposing Release, we do not intend for our standard to require a broker-dealer to provide conflict-free recommendations. For example, under Regulation Best Interest, a broker-dealer could recommend a more expensive or more remunerative security or investment strategy if the broker-dealer has a reasonable basis to believe there are other factors about the security or investment strategy that make it in the best interest of the retail customer, based on that retail customer's investment profile.[127]

We also agree with commenters that we do not 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 in the 913 Study.[128] Nevertheless, we are concerned

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127 See Section II.C.2, Care Obligation.

128 *See* Proposing Release at 21590. As noted in the proposal, among other things, Dodd-Frank Act Section 913(g) expressly provides that the receipt of commission-based

that there is a risk that the "without regard to" language would be inappropriately construed to require a broker-dealer to eliminate all of its conflicts when making a recommendation (i.e., require recommendations that are conflict free), which we believe could ultimately harm retail investors by reducing their access to differing types of investment services and products and by increasing their costs.

The potential for a range of different meanings to be given to the phrase "without regard to" was heightened by the DOL's use of this same language for purposes of the Impartial Conduct Standards set forth in the BIC Exemption. We recognize, as noted by some commenters, that the DOL interpretation of this phrase does not require "conflict-free" recommendations. Nevertheless, because of the differences in the approach to the treatment of conflicts under ERISA and under the federal securities laws—ERISA starts by prohibiting conflicts and then through exemptions permits certain conflicts, whereas the federal securities laws generally start with disclosure and become more restrictive—we share commenters'

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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. Moreover, Section 913(g) does not itself require the imposition of the principal trade provisions of Advisers Act Section 206(3) on broker-dealers. 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. *See* Exchange Act Section 15(k)(1) and Advisers Act Section 211(g)(1). *See also* 913 Study at 113; Proposing Release at 21590.

concerns that DOL's use of the "without regard to" language could alter the way in which conflicts are viewed and cause a substantial portion of conduct that is currently permitted, and reasonably accepted and desired by retail customers, to be limited or eliminated. Based on market participant experience with the implementation of—and reaction to the subsequent overturning of—the DOL Fiduciary Rule, in particular the BIC Exemption,[129] we continue to believe that it is better to use language that provides similar investor protections, but does not raise these legal ambiguities.

The "without placing the financial or other interest . . . ahead of the interest of the retail customer" phrasing recognizes that while a broker-dealer will inevitably have some financial interest in a recommendation—the nature and magnitude of which will vary—the broker-dealer's interests cannot be placed ahead of the retail customer's interest.[130] Accordingly, we believe this phrasing establishes a standard that enhances investor protection by prohibiting a broker-dealer from placing its interests ahead of the retail customer's interests, and preserves investor access (in terms of both choice and cost) to differing types of investment services and products.

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129 *See supra* footnotes 33 and 34 (citing reduction in services and increase in costs following DOL).

130 In this vein, we believe that a broker-dealer's "financial interest" is broad, and that a broker-dealer is unlikely to have an "other interest" that is not a "financial interest." *See, e.g.,* Proposing Release at 21618 (noting "…our interpretation of the types of material conflicts of interest arising from financial incentives is broad…").

The phrasing also aligns with an investment adviser's fiduciary obligation. As discussed in the Fiduciary Interpretation, an investment adviser's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty.[131] The fiduciary duty requires that an adviser "adopt the principal's goals, objectives, or ends."[132] This means the adviser must, at all times, serve the best interest of its clients and not subordinate its client's interest to its own. In other words, the investment adviser cannot place its own interests ahead of the interests of its client.[133] This combination of care and loyalty obligations has been characterized as requiring the investment adviser to act in the "best interest" of its client at all times.[134]

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131 *See, e.g.*, Proxy Voting by Investment Advisers, Advisers Act Release No. 2106 (Jan. 31, 2003) ("Investment Advisers Release No. 2106"). *See also* Fiduciary Interpretation.

132 Arthur B. Laby, *The Fiduciary Obligations as the Adoption of Ends*, 56 Buffalo Law Review 99 (2008); *see also* Restatement (Third) of Agency, §2.02 Scope of Actual Authority (2006) (describing a fiduciary's authority in terms of the fiduciary's reasonable understanding of the principal's manifestations and objectives). *See* Fiduciary Interpretation.

133 *See* Fiduciary Interpretation.

134 *Id*. *See also* Amendments to Form ADV, Advisers Act Release No. 3060 (Jul. 28, 2010) (adopting amendments to Form ADV and stating that "under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients' interests to its own," citing Investment Advisers Act Release 2106). *See SEC v. Tambone*, 550 F.3d 106, 146 (1st Cir. 2008) ("Section 206 imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund…"); *SEC v. Moran*, 944 F. Supp. 286, 297 (S.D.N.Y 1996) ("Investment advisers are entrusted with the responsibility and duty to act in the best interest of their clients.").

Language that would require a broker-dealer to put the retail customer's interest "first" arguably raises many of the same concerns as the "without regard to" language. Accordingly, we are adopting a formulation in Regulation Best Interest that is consistent with how we describe the duty of loyalty for investment advisers in the Fiduciary Interpretation—that is, a requirement not to place the adviser's interests ahead of the interests of its client.[135]

While we are not revising this phrasing of the standard, we appreciate concerns raised by commenters about clarifying whether this standard permits broker-dealers to allow their conflicts to taint their recommendations or to allow broker-dealers to make recommendations that are motivated by their own interests or to put their interests first. We discuss below what it means to "act in the best interests," particularly in the context of satisfying the Care and Conflict of Interest Obligations. Specifically, we clarify that the obligations set forth in Regulation Best Interest are intended to require broker-dealers to take steps to reduce the effect of (and in some cases eliminate) conflicts that create an incentive to place a broker-dealer's or an associated person's interest ahead of the retail customer's interest when making a recommendation, and to make recommendations in the best interest of the retail customer even where conflicts continue

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135 *See* Fiduciary Interpretation at footnote 54 (stating that, in practice, referring to putting a client's interest first is a plain English formulation commonly used by investment advisers to explain their duty of loyalty in a way that may be more understandable to retail clients).

to exist. We believe that this approach will result in a standard of conduct that is consistent with what a reasonable retail customer would expect.[136]

Finally, although our standard draws from key fiduciary principles, for various reasons, including to emphasize that Regulation Best Interest is tailored to the broker-dealer relationship and distinct from the investment adviser fiduciary duty, we are not referring to Regulation Best Interest as a "fiduciary" standard, and we emphasize that Regulation Best Interest is separate from any common law analysis of whether a broker-dealer has fiduciary duties.[137] As noted in

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136 *See, e.g.,* Brian Scholl, *et al.*, SEC Office of the Investor Advocate and RAND Corporation, *The Retail Market for Investment Advice* (2018), *available at* https://www.sec.gov/comments/s7-07-18/s70718-4513005-176009.pdf ("OIAD/RAND"). OIAD/RAND summarized the results of focus groups, indicating that in the context of discussing expectations for standards of conduct, "the groups typically expected that a financial professional who is acting in a client's best interest" to, among other things, "disclose payments they receive that might influence their advice [and] avoid taking higher compensation for selling one product over a similar but less costly product." Further, OIAD/RAND summarized focus group comments on professionals' form of compensation, noting that "although many participants prefer that a professional be compensated by the client alone, some might not rule out using a professional who is receiving other compensation, for example if the compensation is openly disclosed and they are comfortable with the professional." The SEC's Office of Investor Advocate and the RAND Corporation prepared this research report regarding the retail market of investment advice prior to, and separate from, our rulemaking proposals. This report was included in the comment file at https://www.sec.gov/comments/s7-07-18/s70718-4513005-176009.pdf. *See also, e.g.*, Washington, D.C. Roundtable at 49 ("So it seems to me that there is a tight connection between the obligation that you have, and our obligations down below here to the conflicts of interest, that it's really important that advisers or brokers spell out what conflicts of interest they have, and what that means in real terms to the person before they make a choice, for example").

137 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

the proposal, fiduciary standards vary, for example, for investment advisers, banks acting as trustees or fiduciaries, and fiduciaries to ERISA plans. As we have learned through our consideration of the Relationship Summary Proposal, and from various investor studies, using the term "fiduciary" to describe the standard may not sufficiently convey meaning regarding the specific substance of the standard.[138] In addition, we appreciate commenters' concerns that using the term in the context of a different relationship may introduce further legal or compliance ambiguity.[139]

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circumstances. *See* Proposing Release at 21584. 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. *Id.* In developing proposed Regulation Best Interest, the Commission has drawn from principles that apply to investment advice under other regulatory regimes, including state common law fiduciary principles, among others. By doing so, we hope to establish greater consistency in the level of retail customer protections and to make it easier to comply with Regulation Best Interest where other legal regimes, such as state common law drawing upon comparable fiduciary principles, might also apply.

138 *See, e.g.*, RAND 2018 ("Some participants had never heard of the word, whereas others had heard it but did not know what it meant in this context. Others thought the word "fiduciary implies acting in best interest …"). We have modified the standard of conduct disclosure required by Form CRS to eliminate technical words, such as "fiduciary," and describe the standards of conduct of broker-dealers, investment advisers, or dual-registrants using similar terminology in a plain-English manner. In particular, Form CRS uses the term "best interest" to describe how broker-dealers, investment advisers, and dual-registrants must act regarding their retail customers or clients when providing recommendations as a broker-dealer or acting as an investment adviser. *See* Relationship Summary Adopting Release.

139 *See, e.g.*, Stifel Letter.

As articulated in the Proposing Release, we appreciate the desire for clarity about the requirements imposed by Regulation Best Interest, and we have sought to provide such clarity by specifying by rule the specific components with which a broker-dealer is required to comply to satisfy its best interest obligation. The changes we are making from the Proposing Release to this final Regulation Best Interest and the additional interpretations and guidance we are providing are intended to further clarify how a broker-dealer could comply with these requirements.

As noted above and discussed in the Fiduciary Interpretation, an investment adviser's fiduciary duty under the Advisers Act requires the adviser to act in the best interests of its clients. We have chosen to describe the standard by referring directly to what the standard requires at the time a recommendation is made.[140] Furthermore, while key elements of the standard of conduct that applies to broker-dealers under Regulation Best Interest will be substantially similar to key elements of the standard of conduct that applies to investment advisers pursuant to their fiduciary duty under the Advisers Act at the time that a recommendation is made, we are concerned that using the term "fiduciary" to describe a broker-dealer's obligations under Regulation Best Interest may create confusion by suggesting that the standards of conduct are identical in all respects, when there are key differences as noted above, including the scope of the of the duty

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[140] As discussed in the Relationship Summary Adopting Release, we are adopting a requirement in Form CRS for a description of a firm's applicable standard of conduct using prescribed wording.

(e.g., the application of the adviser's fiduciary duty to the entire relationship versus Regulation Best Interest's recommendation-specific application, and the application of an adviser's fiduciary duty to all clients as opposed to Regulation Best Interest's application to retail customers).[141]

Similarly, while we are not harmonizing the phrasing of the best interest standard with the DOL's definition of "best interest" as reflected in the BIC Exemption's Impartial Conduct Standards, as suggested by some commenters,[142] or otherwise adopting some or all conditions of the BIC Exemption, we gave careful consideration to the DOL Fiduciary Rule in developing Regulation Best Interest.[143] Regulation Best Interest takes into account both market participant experience with the implementation of—and reaction to the subsequent overturning of the DOL Fiduciary Rule, in particular the BIC Exemption. As discussed in the Proposing Release, we believe Regulation Best Interest is consistent with many of the key components of the DOL's Impartial Conduct Standards. Regulation Best Interest incorporates principles underlying the DOL Fiduciary Rule—such as the concept of conflict mitigation—that, based on our expertise in regulating the broker-dealer industry, we believe would further our goal of reducing the effect of

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141 *See* Fiduciary Interpretation.

142 *See* AARP August 2018 Letter; Wells Fargo Letter; Schwab Letter; NASAA August 2018 Letter.

143 On March 15, 2018, the DOL Fiduciary Rule was vacated by the United States Court of Appeals for the Fifth Circuit. *Chamber of Commerce v. U.S. Dep't of Labor*, *885 F.3d 360* (5th Cir. 2018).

conflicts on recommendations and would promote recommendations in the best interest of the retail customer even where conflicts continue to exist.

2. General Obligation to "Act in Best Interest"

We agree with commenters that further clarity should be provided on what it means to "act in the best interest" of a retail customer and particularly what it means to make a recommendation in a retail customer's "best interest" under the Care Obligation. In the guidance that follows and in the detailed discussion of each of the Disclosure, Care, Conflict of Interest, and Compliance Obligations in Section II.C below, we provide further clarity on how a broker-dealer acts in a retail customer's best interest when making a recommendation.

First, in response to comments, we are clarifying the relationship between the General Obligation and the specific component obligations described in Section II.C. These specific component obligations expressly set forth what it means to "act in the best interest" of the retail customer in accordance with the General Obligation. As articulated in the proposal, and discussed in more detail in the relevant sections specifically addressing these obligations, these specific component obligations draw on principles underlying the fiduciary duties of care and loyalty interpreted under the Advisers Act and as recommended in the 913 Study. However, we believe that adopting specific regulatory obligations for broker-dealers appropriately reflects the structure and characteristics of broker-dealer relationships with retail customers and the extensive existing regulatory regime applicable to broker-dealers. Regulation Best Interest does not establish a "safe harbor." The specific component obligations of Regulation Best Interest are mandatory, and failure to comply with any of the components would violate the General Obligation. By contrast, compliance with a safe harbor is optional, and failure to comply with the terms of the safe harbor does not necessarily violate the relevant legal requirement.

Second, while we are declining to expressly define "best interest" in the rule text as suggested by some commenters, we are providing interpretations and guidance regarding the application of the specific component obligations and in particular what it means to make a recommendation in the retail customer's "best interest." Consistent with the proposal, compliance with each of the specific component obligations of Regulation Best Interest, including the "best interest" requirement in the Care Obligation, will be applied in a principles-based manner. This principles-based approach to determining what is in the "best interest" is similar to an investment adviser's fiduciary duty, which has worked well for advisers' retail clients and our markets. As proposed, whether a broker-dealer has acted in the retail customer's best interest will turn on an objective assessment of the facts and circumstances of how the specific components of Regulation Best Interest are satisfied at the time that the recommendation is made (and not in hindsight). In particular, whether a broker-dealer's recommendation satisfies the requirements of the Care Obligation is an objective evaluation that is not susceptible to a bright line test; rather it turns on the facts and circumstances of the particular recommendation and the particular retail customer, at the time the recommendation is made. This facts-and-circumstances approach recognizes that one size *does not* fit all, and what is in the best interest of one retail customer may not be in the best interest of another.

We understand that markets evolve and we encourage broker-dealers to have an open dialogue with the Commission and Commission's staff as questions arise.

As a general matter, however, in response to comments, we are changing guidance in the Proposing Release stating that under Regulation Best Interest, a broker-dealer's financial interests cannot be the "predominant motivating factor behind" a recommendation, and 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."[144] Many commenters expressed concerns regarding and requested removal of the "predominantly motivated" language, stating that it contradicted statements that there was no scienter requirement under Regulation Best Interest by requiring a consideration of intent, creating ambiguity as to what extent a broker-dealer's interests could influence its recommendations or requiring a weighing of the broker-dealer's interests against the retail customer's interests.[145] Some commenters, however, indicated support for the "predominantly motivated language" in the context of agreeing with the Commission's proposed "without placing the financial or other interest . . . ahead" phrasing of the best interest standard.[146]

In consideration of these comments, we are modifying these statements to remove this language and to clarify our intent. Specifically, Regulation Best Interest recognizes that while a broker-dealer will inevitably have some financial interest in a recommendation—the nature and magnitude of which will vary—the broker-dealer's interests cannot be placed ahead of the retail customer's interest.[147] Accordingly, Regulation Best Interest will not per se prohibit a broker-

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144 *See* Proposing Release at 21588.

145 *See* CFA August 2018 Letter; Better Markets August 2018 Letter; Wells Fargo Letter.

146 *See* AXA Letter; FSI August 2018 Letter.

147 *See id*. *See infra* Section II.C.2.

dealer from making recommendations where conflicts of interest are present.[148] Instead, Regulation Best Interest includes specific requirements for broker-dealers to address their conflicts of interest.[149] These specific requirements are designed to promote recommendations that are in the best interest of the retail customer despite the existence of these conflicts of interest. In other words, recommendations involving conflicts of interest between the broker-dealer and the retail customer will be permissible under Regulation Best Interest only to the extent that the broker-dealer satisfies the specific requirements of Regulation Best Interest.

Further, for the reasons discussed in the proposal, we confirm that Regulation Best Interest is not intended to limit or eliminate recommendations that encourage diversity in a retail customer's portfolio through investment in a wide range of products, including, when

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148 Such conflicts of interest may include: 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; 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 a complex or an illiquid security); or accepting a retail customer's order that is contrary to the broker-dealer's recommendations. While these practices will 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. *See also* Proposing Release at 21587.

149 *Id* at 21588.

appropriate, products that may involve higher risks or cost to the retail customer, as these products may be in the best interest of certain retail customers at certain times or in certain circumstances.[150] Regulation Best Interest will 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 specific component obligations.[151] In other words, Regulation Best Interest will allow a broker-dealer to recommend products that entail higher costs or risks for the retail customer, or that result in greater compensation to the broker-dealer, or that are more expensive, than other products, provided that the broker-dealer complies with the specific component obligations detailed below,[152] including the requirement to make these recommendations exercising reasonable diligence, care, and skill to have a reasonable basis to believe that the recommendation is in the retail customer's best interest and does not place the broker-dealer's interest ahead of the retail customer's interest.

Finally, some commenters sought additional clarity whether Regulation Best Interest would extend beyond a particular recommendation, impose a duty to monitor the retail customer's account, or apply to unsolicited orders.[153] We confirm that, consistent with the

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150 *Id*.

151 *See id.*

152 *See id*.

153 *See, e.g.*, SIFMA August 2018 Letter; Transamerica August 2018 Letter; *see also generally* CFA August 2018 Letter; Better Markets August 2018 Letter.

Proposing Release and as discussed further below, Regulation Best Interest *would not*: (1) extend beyond a particular recommendation[154] or generally require a broker-dealer to have a continuous duty to a retail customer or impose a duty to monitor;[155] (2) require the broker-dealer to refuse to accept a customer's order that is contrary to the broker-dealer's recommendation; or (3) apply to self-directed or otherwise unsolicited transactions by a retail customer, whether or not she also receives separate recommendations from the broker-dealer.

B. Key Terms and Scope of Best Interest Obligation

1. Natural Person who is an Associated Person

In the Proposing Release, we stated that a "natural person who is an associated person" is a natural person who is an associated person as defined in Section 3(a)(18) of the Exchange Act: "any partner, officer, or 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

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154 However, paragraph (a)(2)(iii)(C) of Regulation Best Interest addresses a series of recommended transactions. *See* Section II.C.2.d.

155 However, as discussed below, it is our position that when a broker-dealer agrees with a retail customer to provide account monitoring services: (1) the broker-dealer would be required to disclose the material facts (including scope and frequency) of those services pursuant to the Disclosure Obligation, and (2) such agreed-upon account monitoring services involve an *implicit* recommendation to hold (*i.e.*, an implicit recommendation not to buy, sell, or exchange assets pursuant to that securities account review) at the time agreed-upon monitoring occurs, which is a recommendation "of any securities transaction or investment strategy involving securities" covered by Regulation Best Interest.

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)."[156] In limiting the term to only a "natural person who is an associated person," we sought to exclude affiliated entities of the broker-dealer that are not themselves broker-dealers, as they are not the intended focus of Regulation Best Interest.[157]

We solicited comment on whether the application of the definition was appropriate, alternative definitions should be considered, or the scope should be broadened or narrowed. We received no comments and, for the reasons discussed in the Proposing Release, are using the term "natural person who is an associated person," consistent with the definition in Section 3(a)(18) of the Exchange Act.[158]

2. Recommendation of Any Securities Transaction or Investment Strategy Involving Securities

We proposed to apply Regulation Best Interest to broker-dealer recommendations of any securities transaction or investment strategy involving securities to a retail customer. We believed that by applying Regulation Best Interest to a "recommendation," as that term is currently interpreted under broker-dealer regulation, we would make clear when the obligation

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156 Proposing Release at 21592-21593.

157 *Id.*

158 *Id.*

applied and would maintain efficiencies for broker-dealers that have already established infrastructures to comply with suitability obligations, which are recommendation-based.[159] Moreover, we believed that focusing on each recommendation would appropriately capture and reflect the various types of recommendations that broker-dealers make to retail customers, whether on an episodic, periodic, or more frequent basis and would help ensure that retail customers receive the protections that Regulation Best Interest is intended to provide. We received numerous comments supporting our general proposed approach to what is a "recommendation," while several commenters suggested modifications regarding the scope of a recommendation or sought additional clarity regarding particular scenarios.[160]

As we indicated in the Proposing Release, in our view, the determination of whether a broker-dealer has made a recommendation that triggers application of Regulation Best Interest should 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. Factors considered in determining whether a recommendation has taken place include whether the communication "reasonably could be viewed as a 'call to action'" and "reasonably would influence an investor

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159 *Id.*

160 *See generally* SIFMA August 2018 Letter; Financial Engines Letter; IPA Letter; Putnam Letter; Cambridge Letter (recommending the Commission adopt FINRA's approach to determining whether a communication is a "recommendation"). *But see* NASAA August 2018 Letter; BlackRock Letter; FSI August 2018 Letter (recommending modifications or clarifications to "recommendation").

to trade a particular security or group of securities."[161] The more individually 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." We continue to believe this general framework regarding what is a recommendation is appropriate, and for the reasons discussed in the Proposing Release, are taking this approach.[162]

While certain commenters recommended formally defining the term "recommendation," including what does not come within that term,[163] other commenters maintained there is no need to define "recommendation" and expressed support for harmonizing the term in accordance with existing broker-dealer guidance and case law.[164] We agree with commenters that clarity is

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161 *See* Proposing Release at 21592-21593; *see also* NASD Notice to Members 01-23, Online Suitability – Suitability Rules and Online Communications (Apr. 2001); Notice of Filing Proposed Rule Change to Adopt FINRA Rule 2090 (Know Your Customer) and FINRA Rule 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. 67218A (Aug. 20, 2010), 75 FR 52562 (Aug. 26, 2010) (discussing what it means to make a "recommendation").

162 *See* Proposing Release at 21592-21593.

163 *See, e.g.*, Prudential Letter (recommending an express definition of "recommendation" that would codify guidance).

164 *See, e.g.*, SIFMA August 2018 Letter ("Similarly, the SEC refers to the FINRA concept of 'recommendation' rather than prescribing a specific definition. We believe this is appropriate, and we believe that a carve-out for educational materials would be consistent with that approach."); Edward Jones Letter ("We do not believe it is necessary for the SEC to define the phrase 'at the time the recommendation is made,' because its meaning is plain."); Cambridge Letter ("FINRA Rule 2111 sets forth an explicit standard for what

important, and we continue to believe that the current principles-based approach underlying existing Commission precedent and guidance will provide effective clarity. Being more prescriptive could result in a definition that is over inclusive, under inclusive, or both.[165] We believe that what constitutes a recommendation is highly fact-specific and not conducive to an express definition in the rule text. Furthermore, we believe that the existing framework has worked well, that broker-dealers generally are familiar with the existing framework, and therefore, that this approach should continue. Accordingly, we are taking the approach as set forth in the Proposing Release, which we believe provides a workable framework and clarity for broker-dealers regarding the contours of a recommendation. To provide further clarity, in response to comments, we describe below the types of communications that we generally view as falling outside of the scope of a recommendation.

We are also generally confirming our interpretation in the Proposing Release of the phrase "any securities transaction or investment strategy involving securities." However, in response to comments regarding the coverage of certain securities or investment strategies, we

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constitutes a recommendation and recognizes 'call to action' as the hallmark. Cambridge believes this definition is fully understood and in use by the industry." Cambridge also states that harmonizing the final rule with existing FINRA rules and guidance will provide clarity to firms, financial professionals, and investors).

165 *See id.*; Proposing Release at 21592-21593. Similarly, FINRA has stated that "defining the term 'recommendation' is unnecessary and would raise many complex issues in the absence of specific facts of a particular case." Exchange Act Release No. 37588, 1996 SEC LEXIS 2285, at *29 (Aug. 20, 1996), 61 FR 44100, 44107 (Aug. 27, 1996).

are providing further clarity regarding our interpretation of this phrase, and in certain instances, refining our interpretation. For example, as discussed more fully below, we are confirming our interpretation that recommendations of "any securities transaction" (purchase, sale, or exchange) and any "investment strategy" involving securities (including an explicit hold recommendation) *are* recommendations "of any securities transaction or investment strategy involving securities."

In addition, we are generally confirming our interpretation that a broker-dealer may agree with a retail customer to take on additional obligations beyond those imposed by Regulation Best Interest, for example, by agreeing with a retail customer to provide monitoring of the retail customer's investments on a periodic basis for purposes of recommending changes in investments.[166] In response to comments, it is our position that when a broker-dealer agrees[167]

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[166] Proposing Release at 21594-21595. The Proposing Release referred to "ongoing" monitoring of the retail customer's investments for purposes of recommending changes in investments. *Id.* In the discussion that follows and the Solely Incidental Interpretation, we are clarifying our views regarding broker-dealer account monitoring services, and the application of Regulation Best Interest to such services. As discussed in the Solely Incidental Interpretation, a broker-dealer that agrees to monitor a retail customer's account on a periodic basis for purposes of providing buy, sell, or hold recommendations may still be considered to provide advice in connection with and reasonably related to effecting securities transactions. Broker-dealers may choose to adopt policies and procedures that, if followed, would help demonstrate that any agreed-upon monitoring is in connection with and reasonably related to the broker-dealer's primary business of effecting securities transactions. *See* Solely Incidental Interpretation.

[167] An agreement to provide account monitoring services to a retail customer is not required to be in writing (although whether or not the broker-dealer is providing account monitoring services, and, if so, the scope and frequency of such monitoring services, must be disclosed in writing pursuant to the Disclosure Obligation). For example, a broker-dealer's oral undertaking that the broker-dealer will monitor the retail customer's

with a retail customer to monitor that customer's account: (1) the broker-dealer is required to disclose the terms of such account monitoring services (including the scope and frequency of those services) pursuant to the Disclosure Obligation[168] and (2) such agreed-upon monitoring involves an *implicit* recommendation to hold (i.e., recommendation not to buy, sell, or exchange assets pursuant to that securities account review) at the time the agreed-upon monitoring occurs, which is a recommendation "of any securities transaction or investment strategy involving securities" covered by Regulation Best Interest.[169] As discussed further below, in our view, a recommendation of "an investment strategy" includes implicit hold recommendations in this

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account on a periodic basis would create an agreement to monitor the account on the terms specified orally. Whether an agreement with the retail customer has been established in the absence of a written agreement or express oral undertaking will depend on an objective inquiry of the particular facts and circumstances, including reasonable retail customer expectations arising from the broker-dealer's course of conduct. In cases where a broker-dealer does not intend to create an implied agreement to monitor the retail customer's account through course of conduct or otherwise, and to avoid ambiguity over whether an implied agreement has been formed, broker-dealers should take steps to ensure that all communications with the retail customer are consistent with its disclosures required under the Disclosure Obligation, which in this case would require the broker-dealer to clearly disclose that the broker-dealer does not monitor the retail customer's account.

168 To avoid ambiguity over whether or when an implicit hold recommendation has been made, this disclosure should identify with specificity when the agreed upon monitoring will occur. *See also* FINRA Regulatory Notice 12-25 at Q14.

169 *See* IAC 2018 Recommendation; NAIFA Letter; AFL-CIO April 2019 Letter; *see also* FINRA Regulatory Notice 12-25, Suitability – Additional Guidance on FINRA's New Suitability Rule (May 2012) at Q3 and accompanying footnotes.

context, where the broker-dealer has agreed to monitor a retail customer's account.[170] We are interpreting the phrase "any security transaction or investment strategy" to include instances where there is an agreement to monitor because in this context there is an implicit recommendation to hold at the time the agreed-upon monitoring occurs when the broker-dealer does not provide an express recommendation to buy, sell, or hold.[171]

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[170] *See* FINRA Rule 2111.03; FINRA Regulatory Notice 12-25. The Commission recognizes that its position with respect to Regulation Best Interest differs from that provided in FINRA guidance regarding whether implicit hold recommendations are subject to the suitability rule. This interpretation applies in the context of the protections of Regulation Best Interest, and does not change the scope of the application of the FINRA suitability rule. Further, while for purposes of Regulation Best Interest implicit hold recommendations are generally recommendations of "any securities transaction or investment strategy regarding securities" where a broker-dealer agrees to provide account monitoring services, we are not otherwise addressing the treatment of implicit hold recommendations in other contexts. In other words, except where a broker-dealer agrees to provide account monitoring services as described, consistent with existing FINRA guidance, Regulation Best Interest will only apply to explicit hold recommendations. *See* FINRA Regulatory Notice 12-25 at Q3 and accompanying footnotes.

[171] Our interpretation is generally consistent with commenters' views regarding the application of Regulation Best Interest to implicit hold recommendations in the context of agreed-upon account monitoring services. *See* IAC 2018 Recommendation ("we believe the best interest standard should be applied to the broker-dealer's monitoring of the customer account, where brokers provide ongoing services to the account. In essence, this would apply the best interest standard to the implicit "no recommendation" recommendation that a broker makes when reviewing the account and recommending no change."); NAIFA Letter (asserting broker-dealers should be free to agree to, and define the nature of, any ongoing relationship via contract, such as including monitoring services). *See also* AFL-CIO April 2019 Letter ("adopt a principles-based obligation to monitor the account, where the nature and extent of the monitoring follows the contours of the relationship"). *See also supra* footnote 166 (encouraging broker-dealers to adopt policies and procedures that, if followed, would help demonstrate that any agreed-upon monitoring is in connection with and reasonably related to the broker-dealer's primary

We recognize that a broker-dealer may voluntarily, and without any agreement with the customer, review the holdings in a retail customer's account for the purposes of determining whether to provide a recommendation to the customer. We do not consider this voluntary review to be "account monitoring," nor would it in itself create an implied agreement with the retail customer to monitor the customer's account. Any explicit recommendation made to the retail customer as a result of any such voluntary review would be subject to Regulation Best Interest.

Finally, in response to comments received, we have modified the rule text to provide that an "investment strategy involving securities" includes "account recommendations." We interpret "account recommendations" to include 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). As discussed in more detail below, we believe that recommendations of securities account types are consistent with the types of recommendations that have been treated as investment strategies,[172] because the type of securities account

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business of effecting securities transactions in accordance with the Solely Incidental Interpretation).

172 Although FINRA has stated that a recommendation concerning the type of workplace retirement plan account in which a customer should hold his retirement investments typically involves a recommended securities transaction, and thus is subject to suitability requirements, FINRA did not address whether such a recommendation would be an investment strategy in the absence of such a recommended securities transaction. FINRA Regulatory Notice 13-45, Rollovers to Individual Retirement Accounts – FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers (Dec. 2013). Taking this approach is consistent with Commission precedent finding a recommendation of a margin strategy to be unsuitable under the NASD suitability rule, in light of the

recommended is an investment strategy that has the potential to greatly affect retail customers' costs and investment returns.[173] For example, different types of securities accounts can offer different features, products, or services, some of which may—or may not—be in the best interest of certain retail customers.[174] Our interpretation is consistent with a majority of the IAC and other commenters that stated that such important recommendations relating to securities are "investment strategies involving securities" and thus within the scope of Regulation Best Interest.[175] We note that, although we are specifically identifying "account recommendations" as

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associated transactions costs and the impact the strategy could have on customer returns. *See F.J. Kaufman & Co*., 50 S.E.C. 164 (1989) (Commission Opinion) (stating that a broker-dealer recommending the purchase of securities using a margin strategy "at a minimum . . . had an obligation to understand that, in light of the applicable transaction costs, the two components of his recommended strategy, when combined, always would have produced returns inferior to those that could have been obtained from one of those components alone.").

173 *See* SEC Office of Investor Education and Advocacy, Updated Investor Bulletin: How Fees and Expenses Affect Your Investment Portfolio (Sep. 2016).

174 In addition to brokerage versus investment advisory accounts, there are also many options or account types within brokerage accounts. For example, brokerage accounts can include: 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). Different brokerage accounts can also offer different levels of services, such as access to online trading, or can offer different products, for example, in higher dollar amount accounts (*e.g.*, access to products with break-points).

175 *See, e.g.*, IAC 2018 Recommendation ("Decisions about which type of account to open have the potential to greatly affect their costs. Moreover, both rollover and account type recommendations are recommendations of an 'investment strategy involving securities' that can have substantial potential long-term impacts on investors. Both types of recommendations inherently involve potential conflicts of interest, making it critical that

an investment strategy involving securities in the rule text, an account recommendation is just one example of an investment strategy.

a. Recommendation

We interpret whether a "recommendation" has been made to a retail customer that triggers the best interest obligation consistent with precedent under the anti-fraud provisions of the federal securities laws as applied to broker-dealers, and with how the term has been applied under the rules of self-regulatory organizations ("SROs").[176] Several commenters supported this approach, and specifically agreed with following the existing facts and circumstances approach as understood under federal securities laws and SRO rules.[177]

Commenters sought additional clarity regarding the scope of a recommendation and in particular whether certain activities or communications would constitute recommendations, and requested that the Commission incorporate or specifically identify exceptions or exclusions such as the exceptions recognized in FINRA Rule 2111.03 (Suitability) or acknowledged by the

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advisers and brokers put their clients' interests ahead of their own in making such recommendations."); Capital Group Letter ("Choosing between a brokerage and an advisory account is an incredibly impactful decision for investors. It is very important that these recommendations be made in the best interest of the retail [customer].").

176 *See* Proposing Release at 21592-21595. In this regard, Regulation Best Interest does not extend beyond a particular recommendation, for example, by imposing a general broker-dealer duty to monitor a customer's account or by applying the duty to unsolicited orders.

177 *See, e.g.*, AXA Letter; SIFMA August 2018 Letter; IPA Letter; Putnam Letter; FSI August 2018 Letter; Cetera August 2018 Letter.

DOL.[178] Some commenters also sought an explicit carve out or confirmation that certain communications, such as general education materials, general retirement planning materials, or

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[178] *See, e.g.*, Prudential Letter; Transamerica August 2018 Letter; SPARK Letter; *see also* 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) 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 took 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* DOL Interpretative Bulletin 96-1; Participant Investment Education, 29 CFR 2509.96-1, 61 FR 29588 (Jun. 11, 1996) (IB 96-1). *See also* DOL, Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice, 81 FR 20945, 20975 (Apr. 8, 2016) (noting that the now vacated DOL Fiduciary Rule would have carved out investment education from the definition of investment advice, incorporating much of IB 96-1).

general retirement communications, including "pure distribution recommendations," are not "recommendations" subject to Regulation Best Interest.[179]

The treatment of certain communications as "education" rather than "recommendations" is well understood by broker-dealers. We generally view the following types of communications as not being recommendations of any securities transaction or investment strategy involving securities as long as they do not include, standing alone or in combination with other communications, a recommendation of a particular security or securities or particular investment strategy involving securities[180]:

- General financial and investment information, including:
    - basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment,

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[179] *See* SPARK Letter; NAGDCA Letter. Similarly, communications regarding participation in a plan and communications to make or increase plan contributions, without more, would generally not come within "recommendation."

[180] This concept also applies to investment strategies. *See* FINRA Regulatory Notice 11-25, Know Your Customer and Suitability – New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations (May 2011) at FAQ 9 ("It is important to note, however, that the suitability rule would not apply to a firm's explanation of a strategy falling outside the safe-harbor provision if a reasonable person would not view the communication as a recommendation. Accordingly, the suitability rule would cover a firm's recommendation that a customer purchase securities using margin, whereas the rule generally would not cover a firm's brochure that simply explains the risks and benefits of margin without suggesting that the customer take action.").

- historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices,
- effects of inflation,
- estimates of future retirement income needs, and
- assessment of a customer's investment profile;

- 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;[181]
- Asset allocation models that are:
  - 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;[182] and

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[181] While this descriptive information would be treated as "education" rather than a "recommendation," we caution broker-dealers to ensure that communications by their associated persons intended as "education" do not cross the line into "recommendations." *See* FINRA Regulatory Notice 13-45.

- Interactive investment materials that incorporate the above.

Thus, for example, a general conversation about retirement planning, such as providing a company's retirement plan options to a retail customer, would not, by itself, rise to the level of a recommendation. Similarly, where a broker-dealer informs a retail customer that he or she needs to take a required minimum distribution under the Internal Revenue Code, we would not interpret such communication, by itself, to rise to the level of a recommendation. Such a communication would be considered investment education or descriptive information, provided it does not involve, for example, a recommendation regarding specific securities to be sold or a recommendation regarding specific securities to be purchased with the proceeds of any sale.[183] We agree with commenters that Regulation Best Interest should not stifle investment education as a means to encourage financial wellness, or otherwise restrict broker-dealers from

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[182] In this regard, as an allocation recommendation becomes narrower or more specific, the recommendation gets closer to becoming a recommendation of particular securities and, thus, subject to the suitability rule. *See* FINRA Regulatory Notice 12-25 at FAQ 8.

[183] *See, e.g.*, SPARK Letter (asking for confirmation that "pure 'distribution recommendations' involving retirement accounts, such as those required under Internal Revenue Code section 401(a)(9), are not a 'recommendation of any securities transaction or investment strategy involving securities.'"). However, informing a retail customer about a required minimum distribution may become a recommendation where a broker-dealer includes (standing alone or in combination with other communications) a recommendation of, or regarding, a particular security or securities or an investment strategy involving securities. *See* FINRA Rule 2111 (Suitability) FAQ.

disseminating information about, for example, retirement plans, and the approach we are taking to what is or is not considered a "recommendation" achieves this goal.[184]

b. Interpretation of Any Securities Transaction or Investment Strategy Involving Securities

As proposed, Regulation Best Interest would apply to recommendations of "any securities transaction" (purchase, sale, and exchange) and any "investment strategy" involving securities (including explicit recommendations to hold a security or regarding the manner in which it is to be purchased or sold). In addition, the Proposing Release stated that securities transactions or investment strategies involving securities might 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 from a retirement plan.[185] Finally, although we did not propose to cover account type recommendations generally, we noted that evaluating the appropriateness of the type of account is an issue that relates to both broker-dealers and investment advisers, and requested comment on whether and how we should address this type of recommendation.

In response to the Proposing Release, several commenters supported the Commission's approach; however, several commenters also requested modifications or clarifications regarding

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184 *See* SPARK Letter (suggesting expressly excluding beneficial conversations about retirement savings and "ensuring that Regulation Best Interest does not discourage broker-dealers in any way from having these important conversations with retirement investors"); *see also* Transamerica August 2018 Letter (suggesting the exclusion of various conversations designed to facilitate retirement savings).

185 *See* Proposing Release at 21595.

products or strategies covered under Regulation Best Interest. For example, a majority of the IAC and numerous commenters highlighted the conflicts of interest associated with account type recommendations, and urged the Commission to apply Regulation Best Interest to account type recommendations generally, and to IRA rollovers.[186] Relatedly, several commenters sought clarity regarding whether and when a rollover or account type recommendation would be a "recommendation" under Regulation Best Interest.[187]

After careful consideration of comments and feedback, the Commission has modified the rule text to state that an "investment strategy involving securities" includes "account recommendations." We interpret "account recommendations" to include recommendations by broker-dealers of securities account types generally,[188] as well as recommendations to roll over

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186 *See, e.g.,* IAC 2018 Recommendation (supporting the "expan[sion] of the best interest obligation to cover rollover recommendations and recommendations by dual registrant firms regarding account types"); *see also* NASAA August 2018 Letter; SPARK Letter; Financial Engines Letter; Cetera August 2018 Letter; AFL-CIO April 2019 Letter. *But see* SIFMA August 2018 Letter (viewing recommendations of an account type as not involving a recommendation of a securities transaction or investment strategy involving securities).

187 *See, e.g.*, NAGDCA Letter; FPC Letter.

188 In the discussion of the Care Obligation in Section II.C.2, we are also setting forth additional positions regarding the application of the Care Obligation to account type recommendations, as well as recommendations to roll over or transfer assets from one account to another. *See also* Fiduciary Interpretation (explaining that "[a]dvice about account type includes advice about whether to open or invest through a certain type of account (*e.g.*, a commission-based brokerage account or a fee-based advisory account) and advice about whether to roll over assets from one account (*e.g.*, a retirement account) into a new or existing account that the adviser or an affiliate of the adviser manages").

or transfer assets from one type of account to another (e.g., workplace retirement plan account to an IRA).[189] In addition, the Commission is stating its view that "any securities transaction or investment strategy involving securities" not only includes explicit hold recommendations, but also includes implicit hold recommendations that are the result of agreed-upon account monitoring between the broker-dealer and retail customer.[190]

Account Recommendations

The Proposing Release indicated that securities transactions or investment strategies involving securities could 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 a workplace retirement plan account to an IRA, and requested comment on whether and how to address account type recommendations.

Several commenters suggested expanding Regulation Best Interest to explicitly cover rollover recommendations and recommendations by firms regarding account types. For example, a majority of the IAC explained that rollover recommendations "are frequently provided at a critical juncture in an investor's life—retirement—and are often irrevocable decisions," and

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189 A majority of the IAC and numerous commenters expressed the importance of account rollovers and the need for rollovers to be covered under Regulation Best Interest. *See, e.g.*, IAC 2018 Recommendation; Financial Engines Letter.

190 Several commenters stated that broker-dealers should be able to contract with retail customers to provide additional services, such as account monitoring, and that such agreed upon services should be subject to Regulation Best Interest. *See, e.g.,* NAIFA Letter; IAA August 2018 Letter; AFL-CIO April 2019 Letter.

further noted that "[d]ecisions about which type of account to open have the potential to greatly affect [retail customers'] costs" and that both rollovers and account type recommendations can "have substantial potential long-term impacts on investors."[191] Another commenter noted that "[r]etirees have no practical ability to recoup lost spending power by returning to work and setting aside additional retirement savings, so they are particularly vulnerable to the adverse consequences of poor advice and high expenses."[192] Finally, a majority of the IAC and several commenters noted that broker-dealers and investment advisers alike have a strong economic incentive to recommend investors roll over plan assets into an IRA or otherwise transfer assets to open an account with the broker-dealer or investment adviser.[193]

After consideration of comments received, including concerns expressed about the conflicts associated with recommendations of account types, IRA rollovers and retirement advice more broadly, it is our view that Regulation Best Interest should apply broadly to recommendations of securities transactions and investment strategies involving securities. Accordingly, the Commission is including in the rule text account recommendations as recommendations that will be covered by Regulation Best. "Account recommendations" include

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191 IAC 2018 Recommendation. *See also* Letter from Brian H. Graff, Executive Director and CEO, Craig P. Hoffman, General Counsel, Doug Fisher, Director of Retirement Policy, American Retirement Association ("ARA") (Dec. 13, 2018) ("ARA December 2018 Letter"); Transamerica August 2018 Letter.

192 Fiduciary Benchmarks Letter.

193 *See, e.g.*, IAC 2018 Recommendation; NASAA August 2018 Letter; Fiduciary Benchmarks Letter.

recommendations of securities account types generally (e.g., to open an IRA or other brokerage account), as well as recommendations to roll over or transfer assets from one type of account to another (e.g., a workplace retirement plan account to an IRA).

Although account recommendations, including recommendations of a securities account type generally, as well as recommendations to roll over assets from a workplace retirement plan account to an IRA or to open an IRA held at the broker-dealer, will almost always involve a "securities transaction" (such as a securities purchase, sale, or exchange), and thus would generally be subject to Regulation Best Interest, we are modifying the rule text to provide that such recommendations are "investment strategies involving securities" for purposes of Regulation Best Interest, regardless of whether they are tied to a specific securities transaction.[194] Existing broker-dealer regulation and guidance stresses that the term "investment strategy" is to be interpreted broadly, and would include, among others, recommendations generally to use a bond ladder, day trading, "liquefied home equity," or margin strategy involving securities, irrespective of whether the recommendations mention particular securities.[195] This approach appropriately recognizes that customers may rely on firms' and

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194 A recommendation that a retail customer roll over or transfer assets to an IRA held at the broker-dealer, or open an IRA or another securities account with a broker-dealer, presumes that the recommendation would involve transactions in securities, even if the rollover or account recommendation does not result in transactions or transaction-based compensation.

195 *See* FINRA Rule 2111.03; FINRA Regulatory Notice 12-25 at Q7.

associated persons' investment expertise and knowledge, and therefore the broker-dealer should be responsible for such recommendations, regardless of whether those recommendations result in transactions or generate transaction-based compensation.[196]

Account recommendations, including recommendations of securities account types generally (e.g., to open an IRA or other brokerage account), and recommendations to roll over or transfer assets into an IRA or another securities account, are consistent with the types of recommendations that have been treated as investment strategies under existing suitability rules.[197] Specifically, like other investment strategies, account recommendations are recommendations of an approach or method (i.e., a "strategy") for how a retail customer should engage in transactions in securities, involve conflicts of interest, and can have long-term effects on investors' costs and returns from their investments.[198] In addition, we believe retail customers rely on broker-dealers' and associated persons' investment expertise and knowledge with respect to such recommendations. As a result, such recommendations must be made consistent with the retail customer's objectives and needs (i.e., investment profile), irrespective of whether those recommendations are tied to a specific securities transaction. Consistent with a

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196 *See* FINRA Regulatory Notice 11-02, Know Your Customer and Suitability – SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations (Jan. 2011).

197 *See supra* footnotes 172 and 173.

198 *See* Capital Group Letter; *see also* IAC 2018 Recommendation; NASAA August 2018 Letter.

majority of the IAC's and other commenters' suggestions, we are modifying the rule text to state that the term "investment strategy involving securities" includes "account recommendations," which we interpret to include recommendations of securities account types generally, as well as recommendations to roll over or transfer assets.[199]

Thus, such account recommendations will be subject to Regulation Best Interest even if there is not a recommendation of a securities transaction. Although we proposed only covering account type recommendations that are tied to securities transactions, and not account type recommendations generally, we agree with commenters and a majority of the IAC that consistent with other investment strategies involving securities, securities account type recommendations should be covered under Regulation Best Interest regardless of whether those recommendations result in transactions or generate transaction-based compensation.[200] In addition, as discussed in the Fiduciary Interpretation, investment advisers' fiduciary duty applies to advice to clients about account types, which satisfies the concerns about parity set forth in the Proposing Release and protects retail customers of broker-dealers and retail clients of investment advisers alike.[201]

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199 *See, e.g.*, IAC 2018 Recommendation; Capital Group Letter ("Choosing between a brokerage and an advisory account is an incredibly impactful decision for investors. It is very important that these recommendations be made in the best interest of the retail [customer].").

200 *See, e.g.,* IAC 2018 Recommendation; NASAA August 2018 Letter.

201 *See* Fiduciary Interpretation.

Where a financial professional who is dually registered (i.e., an associated person of a broker-dealer and a supervised person of an investment adviser (regardless of whether the professional works for a dual-registrant, affiliated firm, or unaffiliated firm)) is making an account recommendation to a retail customer,[202] whether Regulation Best Interest or the Advisers Act will apply will depend on the capacity in which the financial professional making the recommendation is acting.[203] As discussed further in the Care Obligation, if the individual is acting as a broker-dealer or associated person thereof, he or she must comply with Regulation Best Interest and will need to take into consideration all types of accounts offered by the

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202 As discussed in more detail below in Section II.B.3.b, Regulation Best Interest applies to a retail customer who receives a recommendation and *uses* the recommendation. Among other things, we interpret a retail customer to *use* a recommendation when: (1) the retail customer opens a brokerage account with the broker-dealer, regardless of whether the broker-dealer receives compensation; (2) the retail customer has an existing account with the broker-dealer and receives a recommendation from the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation; or (3) the broker-dealer receives or will receive compensation, directly or indirectly as a result of that recommendation, even if that retail customer does not have an account at the firm.

203 *See* Section II.B.3.d, below for discussion of factors the Commission will consider in determining capacity. *See also* Fiduciary Interpretation at footnotes 42-44 and accompanying text. As discussed in the Fiduciary Interpretation, while advice to prospective clients about these matters is subject to the antifraud provisions under section 206 of the Advisers Act, the adviser must also satisfy its fiduciary duty with respect to any such advice (*e.g.*, regarding account type) once a prospective client becomes a client. Thus, at the point in time at which the prospective client becomes a client of the investment adviser (*e.g.*, at account opening), the fiduciary duty applies. *Id*.

financial professional (i.e., both brokerage and advisory accounts) when making the recommendation of an account that is in the retail customer's best interest.

In the case of an account recommendation by a financial professional who is only registered as an associated person of broker-dealer (regardless of whether that broker-dealer entity is a dual-registrant or affiliated with an investment adviser), Regulation Best Interest will apply to the recommendation. Further, the associated person can only recommend a brokerage account that the broker-dealer offers when the associated person has a reasonable basis to believe that the recommended brokerage account is in the best interest of the retail customer and the broker-dealer otherwise complies with Regulation Best Interest.

Regulation Best Interest would apply to account recommendations by the dual-registrant firm, and consistent with the Conflict of Interest Obligation, the firm would need to, among other things, establish, maintain and enforce policies and procedures to identify, disclose, and mitigate, any incentives for an associated person of the broker-dealer to place the interest of the firm or the associated person ahead of the interests of the retail customer.

In the discussion of the Care Obligation below, we discuss how a broker-dealer and associated persons of a broker-dealer can make recommendations of securities account types, including recommendations to open an IRA or to roll over assets into an IRA, in the best interest of the retail customer.

Hold Recommendations

The Proposing Release stated that Regulation Best Interest would apply to any securities transaction or investment strategy involving securities, including explicit recommendations to hold a security or regarding the manner in which it is to be purchased or sold to retail customers.[204] The Proposing Release also recognized that broker-dealers 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 provide periodic or ongoing services, such as ongoing monitoring of the retail customer's investments for purposes of recommending changes in investments.[205] To the extent that a broker-dealer takes on such additional obligations, the Proposing Release indicated that Regulation Best Interest would apply to any recommendations about securities or investment strategies involving securities made to retail customers resulting from such services.

Several commenters agreed that broker-dealers should be able to contract with retail customers for additional services and be able to expand the relationship on their own terms, while other commenters recommended that a duty to monitor apply to broker-dealers depending

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204 Proposing Release at 21593-21595.

205 *Id*. We also asked whether broker-dealers who provide ongoing monitoring should be considered investment advisers. *Id.* at 21592.

on the facts and circumstances.[206] Other commenters suggested that the Commission not impose a duty to monitor brokerage accounts.[207]

We are confirming that, consistent with existing broker-dealer regulation, Regulation Best Interest will apply to explicit recommendations to hold a security or securities.[208] We are also confirming that Regulation Best Interest does not impose a duty to monitor a retail customer's account. We agree, however, with commenters that Regulation Best Interest should apply to any recommendations that result from the account monitoring services that a broker-dealer agrees to provide.[209] We believe that any monitoring service agreed to by the broker-dealer, the scope and frequency of which would be required to be disclosed pursuant to the Disclosure Obligation, would be covered by Regulation Best Interest, as these activities will

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206 *See, e.g.*, NAIFA Letter ("Additionally, while the best interest standard applies to each recommendation and may not be waived or modified by contract as it applies to those recommendations, it should not be interpreted to create obligations with respect to other, expanded services (e.g., ongoing research and monitoring services, regular in-person meetings, etc.). Again, however, advisors and consumers may agree to expand the relationship in these ways on their own terms."); *see also* CFA August 2018 Letter; Better Markets August 2018 Letter (recommending the Commission establish a duty to monitor depending on the facts and circumstances); AFL-CIO April 2019 Letter.

We note that additional commenters maintained that if broker-dealers agree with retail customers to provide ongoing monitoring for purposes of recommending changes in investments, they should be considered investment advisers. *See* NASAA August 2018 Letter; FPC Letter. We have addressed these comments in the context of the Solely Incidental Interpretation. *See* Solely Incidental Interpretation.

207 *See* IAA August 2018 Letter.

208 *See* FINRA Regulatory Notice 12-25.

209 *See* NAIFA Letter; IAA August 2018 Letter.

result in a recommendation to purchase, sell, or hold a security, or the manner in which to purchase, sell, or hold a security, at each time the agreed-upon monitoring occurs.[210] Thus, by agreeing to perform account monitoring services, the broker-dealer is taking on an obligation to review and make recommendations with respect to that account (e.g., to buy, sell or hold) on that specified, periodic basis.[211] For example, if a broker-dealer agrees to monitor the retail customer's account on a quarterly basis, the quarterly review and each resulting recommendation to purchase, sell, or hold, will be a recommendation subject to Regulation Best Interest. This is the case even in instances where the broker-dealer does not communicate any recommendation to the retail customer. We believe that such an "implicit" recommendation to hold in this context should be covered under Regulation Best Interest in addition to "explicit" recommendations to hold.[212]

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210 In agreeing to provide any account monitoring services, broker-dealers need to consider whether the monitoring services fit within the broker-dealer exclusion from the Advisers Act. *See* Solely Incidental Interpretation.

211 The broker-dealer would also be required to disclose the existence, scope, and frequency of such account monitoring services pursuant to the Disclosure Obligation. To avoid ambiguity over whether or when an implicit hold recommendation has been made, this disclosure should identify with specificity when the agreed upon monitoring will occur.

212 *See* FINRA Rule 2111.03 (noting "[t]he phrase 'investment strategy involving a security or securities' used in this Rule is to be interpreted broadly and would include, among other things, an explicit recommendation to hold a security or securities."); *see also* NASAA August 2018 Letter.

This position differs from FINRA guidance, which generally states that the FINRA suitability rule does not cover an implicit recommendation to hold.[213] We believe that "implicit" hold recommendations in this context, where the broker-dealer agrees to provide specified account monitoring services, are similar to explicit hold recommendations that are considered "investment strategies" because they would constitute the type of recommendations that retail customers would be expected to rely upon and would be a "call to action" in the sense of a recommendation that the customer stay the course.[214] We believe that, in this context, silence is

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213 FINRA Regulatory Notice 11-25 at Q7 ("The rule, for instance, would not apply where an associated person remains silent regarding, or refrains from recommending the sale of, securities held in an account. That is true regardless of whether the associated person previously recommended the purchase of the securities, the customer purchased them without a recommendation, or the customer transferred them into the account from another firm where the same or a different associated person had handled the account."). *See also id.* at footnote 21 ("To the extent that a customer account at a broker-dealer can be discretionary under applicable federal securities laws, the suitability rule generally would not apply where a firm refrains from selling a security. The rule states that it applies to explicit recommendations to hold. Unless the facts indicate that an associated person's failure to sell securities in a discretionary account was intended as or tantamount to an explicit recommendation to hold, FINRA would not view the associated person's inaction or silence in such circumstances as a recommendation to hold the securities for purposes of the suitability rule.").

214 *See* FINRA Regulatory Notice 11-25 at Q7 ("The rule would apply, for example, when an associated person meets with a customer during a quarterly or annual investment review and explicitly advises the customer not to sell any securities in or make any changes to the account or portfolio."). While the FINRA guidance goes on to state that the rule generally would not cover an implicit recommendation to hold, it does not address the particular scenario in which a broker-dealer agrees to monitor an account (such as a quarterly review) and discloses the terms of that monitoring, and then during that review is silent on whether the customer should make any changes. *Id.*; *see also* FINRA Regulatory Notice 12-25 at Q3 and accompanying footnotes.

tantamount to an explicit recommendation to hold, and should be viewed as a recommendation to hold the securities for purposes of Regulation Best Interest.[215] Our interpretation that the term "investment strategy involving securities" includes implicit recommendations to hold that result from an agreement to monitor, at the time the agreed-upon monitoring occurs, is generally consistent with the treatment of similar broker-dealer communications as "investment strategies," and applies the Regulation Best Interest protections to retail customers relying on a broker-dealer's agreement to monitor the customer's account.[216]

Although for purposes of Regulation Best Interest, implicit hold recommendations will be considered a recommendation of "any securities transaction or investment strategy regarding securities" where a broker-dealer has agreed to provide account monitoring services, we are not otherwise changing the treatment of implicit hold recommendations in other contexts. In other words, unless the broker-dealer has agreed to provide account monitoring services as described, Regulation Best Interest would only apply to explicit—*and not to implicit*—hold

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215 *See* FINRA Regulatory Notice 11-25 at footnote 21.

216 Our interpretation is generally consistent with a majority of the IAC's and other commenters' views regarding application of Regulation Best Interest to implicit hold recommendations in the context of agreed-upon account monitoring services. *See* IAC 2018 Recommendation ("We believe the best interest standard should be applied to the broker-dealer's monitoring of the customer account, where brokers provide ongoing services to the account. In essence, this would apply the best interest standard to the implicit "no recommendation" recommendation that a broker makes when reviewing the account and recommends no change."); NAIFA Letter (asserting broker-dealers should be free to agree to, and define the nature of, any ongoing relationship via contract, such as including monitoring services); AFL-CIO April 2019 Letter.

recommendations regarding security positions in an account.[217] This is consistent with the fact that Regulation Best Interest would not impose a duty to monitor customer accounts.[218]

Finally, although certain commenters stated that account monitoring services should only be performed by investment advisers,[219] we reiterate that Regulation Best Interest does not change the scope of account monitoring that broker-dealers may agree to provide, nor does it change the scope of activities that would come within the "solely incidental" prong of the broker-dealer exclusion to the definition of "investment adviser" in the Advisers Act. We recognize that a broker-dealer may voluntarily, and without any agreement with the customer, review the holdings in a retail customer's account for the purpose of determining whether to provide a recommendation to the customer. We view this voluntary review—and any subsequent recommendation to the customer—as in connection with and reasonably related to the broker-dealer's primary business of effecting securities transactions.[220]

Recommendations Involving Retirement Accounts

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217 FINRA Notice to Members 11-25 at Q7.

218 Our approach does not require broker-dealers to undertake account monitoring, unless they choose to do so. *See* Solely Incidental Interpretation.

219 *See, e.g.*, NASAA August 2018 Letter; FPC Letter.

220 *See* Solely Incidental Interpretation. Absent an agreement with the customer (which would be required to be disclosed pursuant to the Disclosure Obligation), we do not consider this voluntary review to be "account monitoring" nor would it in itself create an obligation under Regulation Best Interest, provided of course that any recommendation made to the customer as a result of any such voluntary review would be subject to Regulation Best Interest.

Furthermore, based on comments, our position is that recommendations to retail customers regarding retirement accounts would also be subject to Regulation Best Interest where they involve securities transactions or investment strategies involving securities. We agree with commenters that recommendations to retail customers to take distributions from proceeds of specific securities or to take in-service loans from an employer-sponsored plan are recommendations of a securities transaction, as they would involve a recommendation to sell a security.[221] However, while such recommendations to take plan distributions are "recommendations" and thereby subject to Regulation Best Interest, we reiterate that general communications by broker-dealers relating to distributions in the context of a required minimum distribution or education regarding a plan's options would not, by themselves, constitute recommendations that would be subject to Regulation Best Interest.[222]

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221 *See supra* footnotes 185-189 and accompanying text. *See, e.g.*, NASAA August 2018 Letter; Fiduciary Benchmarks Letter; IAC 2018 Recommendation.

222 For example, where a broker-dealer informs a retail customer that based on age and other relevant factors, he or she needs to take a required minimum distribution, but does not otherwise recommend specifics, such as what securities to sell, or where to place the proceeds, the communication would generally not be a "recommendation" subject to Regulation Best Interest. As with other communications subject to broker-dealer regulation, an inquiry of whether a "recommendation" was made would depend on the facts and circumstances relating to the communication, as discussed more fully above. *See supra* Section II.B.2.a.

3. Retail Customer

We proposed 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."[223] The definition was generally intended to track the definition of "retail customer" under Section 913(a) of the Dodd-Frank Act with some differences, as described in the Proposing Release.[224]

In proposing the definition, we intended to exclude recommendations related to commercial or business purposes but for the definition to remain sufficiently broad to capture recommendations related to the various reasons retail customers may invest, such as saving for retirement, education expenses and other savings purposes. As such, the proposed definition applied to any persons who receive a recommendation from a broker or dealer or a natural person who is an associated person of a broker or dealer, provided that the recommendation is primarily for personal, family or household purposes. In the case of dual-registrants, the proposed

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223 As we stated in the Proposing Release, we believe that broker-dealers would generally be required to obtain sufficient facts about a customer to determine an account's primary purpose for purposes of Regulation Best Interest. *See* Proposing Release at 21595.

224 *See* Proposing Release at Section II.C.4. Section 913(a) defines "retail customer" as a natural person, or the legal representative of such natural person who: (1) receives personalized investment advice about securities from a broker or dealer or investment adviser; and (2) uses such advice primarily for personal, family, or household purposes.

definition was intended to apply only to recommendations made by broker-dealers in their brokerage capacity, based on a facts and circumstances analysis and consistent with existing guidance.[225] The proposed definition differed from the definition of "retail investor" in the Relationship Summary Proposal as the Relationship Summary was intended for a broader range of investors.[226]

The Commission requested comment on the scope and definition of retail customer and received a range of comments requesting: modification of the definition to focus on natural persons; clarification of the "personal, family or household purposes" qualification; harmonization with the definition in Form CRS; and further guidance surrounding the treatment of dual-registrants. In consideration of the comments received, the Commission is modifying the definition of "retail customer" to mean 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.

The revised definition shifts the focus to natural persons, as opposed to any persons, but otherwise it is adopted largely as proposed. However, as discussed below, the Commission is

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225 *Id.*

226 *Id.*

providing additional interpretations, guidance and clarification regarding: the interpretation of the "personal, family, or household purposes" qualifier; the interaction of this definition with the definition of "retail investor" in Form CRS; what it means for a retail customer to "use" the recommendation; and the status of dual-registrants. Furthermore, we are providing guidance on who would be considered to be the legal representative of a natural person for purposes of this definition.

a. Focus on Natural Persons and Legal Representatives of Natural Persons

The Commission proposed to extend the definition of "retail customer" in Regulation Best Interest beyond natural persons to any persons to cover non-natural persons (e.g., trusts that represent the assets of a natural person), which the Commission stated it believed would benefit from the protections of Regulation Best Interest.

Commenters generally suggested that the definition of retail customer be modified to focus on natural persons.[227] To that end, a number of commenters suggested eliminating the "personal, family or household purposes" qualifier from the definition under Dodd-Frank Section 913.[228] Many commenters suggested excluding institutional investors and professional advisers

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227 *See, e.g.,* Cetera August 2018 Letter; Invesco Letter.

228 *See* FPC Letter; SIFMA August 2018 Letter; BlackRock Letter. *Contra* ACLI Letter (supporting the provision in Section 913 and positing that Regulation Best Interest appropriately implements this foundational threshold).

or fiduciaries, including retirement plan representatives[229] and family offices,[230] while a few stated that non-professional plan fiduciaries should have the same protections as retail customers.[231] Many commenters suggested harmonizing the definition with FINRA's definition,[232] in particular, by excluding: (1) institutional accounts that would be exempted from certain suitability protections under FINRA Rule 2111 (Suitability)[233] or (2) institutional investors as defined in Rule 2210 (Communications with the Public),[234] which is broader[235] and would include, among others, certain workplace retirement plans. Conversely, a few

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229 *See, e.g.,* SIFMA August 2018 Letter; Vanguard Letter; Prudential Letter; ICI Letter; Fidelity Letter.

230 *See, e.g.,* TIAA Letter; SIFMA August 2018 Letter; Letter from Stuart J. Kaswell, Executive Vice President and Managing Director, Managed Funds Association, and Jiri Krol, Deputy CEO, Global Head of Government Affairs, Alternative Investment Management Association (Aug. 7, 2018) ("Managed Funds Association Letter").

231 ARA August 2018 Letter; CFA August 2018 Letter.

232 *See, e.g.,* UBS Letter; Bank of America Letter; Raymond James Letter; TIAA Letter; Letter from Joseph Giovanniello, Ladenburg Thalmann Financial Services Inc. (Jul. 30, 2018) ("Ladenburg Letter").

233 FINRA Rule 2111(b). Institutional accounts include banks, savings and loan associations, insurance companies, registered investment companies, state and federal registered investment advisers, and other persons with total assets of at least $50 million.

234 FINRA Rule 2210(a)(4). Institutional investors include, in addition to persons with institutional accounts, government entities and their subdivisions, employee benefit plans, qualified plans as defined in Exchange Act Section 3(a)(12)(C), broker-dealers and registered representatives, and persons acting solely on behalf of such institutional investors.

235 *See, e.g.,* SIFMA August 2018 Letter; TIAA Letter; IPA Letter.

commenters believed that Regulation Best Interest should apply to both retail and institutional customers.[236]

In response to comments, we are modifying the definition to focus on natural persons and their legal representatives, and are clarifying that we interpret "legal representatives" to mean non-professional legal representatives of a natural person, as we discuss below. We believe this change and clarification provides more certainty that institutions and certain professional fiduciaries are not covered for purposes of Regulation Best Interest. It would also retain, however, coverage of certain legal entities (i.e., trusts that represent the assets of a natural person) specifically identified in the Proposing Release as "retail customers" within the scope of Regulation Best Interest, but would not exclude certain high-net-worth natural persons, as was suggested by some commenters[237] to match the current FINRA exclusion of such natural persons from customer-specific suitability requirements.[238]

While the Commission recognizes commenters' concerns regarding compliance costs and burdens if the definition of retail customer does not align with FINRA's exclusion of certain

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236 NASAA August 2018 Letter, Better Markets August 2018 Letter; FPC Letter. *But see* Managed Funds Association Letter (suggesting that sophisticated investors should not be treated as retail customers).

237 *See, e.g.*, Morgan Stanley Letter; FSI August 2018 Letter.

238 *See* FINRA Rule 4512(c), which includes within the definition of "institutional account" any person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million. Currently, under FINRA rules, broker-dealers are exempt from the customer-specific suitability obligations with respect to these "institutional accounts" if certain conditions are met. FINRA Rule 2111(b).

institutional accounts and institutional investors, we have decided not to align our definition with FINRA's exclusion because we believe conflicted recommendations can also result in harm to high net-worth individuals.[239] We believe the benefits of Regulation Best Interest justify compliance costs as these individuals could benefit from the protections included in Regulation Best Interest regardless of their net worth, which may not necessarily correlate to a particular level of financial sophistication.[240]

In addition, we view a "legal representative" of a natural person to only cover non-professional legal representatives (e.g., a non-professional trustee that represents the assets of a

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239 The Commission has brought numerous enforcement actions against financial professionals engaged in schemes to defraud certain high net-worth individuals, in particular, professional athletes. *See, e.g. SEC v. Charles A. Banks, IV,* Civil Action No. 16-CV-3399-TWT (N.D. Ga. Nov. 2, 2018) (former investment adviser who fraudulently induced a former professional athlete to invest $7.5 million in a sports team and apparel merchandise company based on a series of misrepresentations); *SEC v. Ash Narayan, The Ticket Reserve Inc. a/k/a Forward Market Media, Inc., Richard M. Harmon, and John A. Kaptrosky*, Civil Action No. 16-CV-1417-M (N.D. Tex. May 24, 2016) (investment adviser who misappropriated millions of dollars from accounts he managed for professional athletes and invested them in online sports and entertainment ticket business on whose board he served).

In addition, reports indicate deficiencies in financial literary among the general population of retail investors. *See* Federal Research Division, Library of Congress, *Financial Literacy Among Retail Investors in the United States* (Dec. 30, 2011) at 25, *available at* https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part2.pdf ("Library of Congress Report").

240 *See* Primerica Letter (noting challenges in using wealth and education as proxies for investment sophistication).

In addition, the definition of "retail customer" under Section 913(a) of the Dodd-Frank Act did not make a distinction based on net worth.

natural person and similar representatives such as executors, conservators, and persons holding a power of attorney for a natural person),[241] thereby excluding certain institutions from Regulation Best Interest's coverage. In capturing non-professional legal representatives within the definition of retail customer, we are providing the protections of Regulation Best Interest to non-professional persons who are acting on behalf of natural persons but who are not regulated financial services industry professionals retained by natural persons to exercise independent professional judgment, such as registered investment advisers and broker-dealers, corporate fiduciaries (e.g., banks, trust companies and similar financial institutions) and insurance companies, and the employees or other regulated representatives of such advisers, broker-dealers, corporate fiduciaries and insurance companies.[242] Our definition is intended to capture natural persons and their legal representatives who rely directly on the broker-dealer for the recommendation. Accordingly, such non-professional legal representatives would not include regulated financial industry professionals. We believe this responds to commenters who stated that it should not be necessary to provide the protections of Regulation Best Interest to regulated professionals.[243] Importantly, however, this will not relieve firms or financial professionals

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241 A non-professional legal representative is covered pursuant to this rule even if another person is a trustee or managing agent of the trust.

242 *See also* Relationship Summary Adopting Release.

243 *See, e.g.,* Bank of America Letter; Invesco Letter; Letter from Bob Grohowski, Senior Legal Counsel, and Jon Siegel, Senior Legal Counsel, T. Rowe Price (Aug. 10, 2018) ("T. Rowe Letter"); Oppenheimer Letter; ICI Letter.

retained to represent the assets of natural persons from their own obligations to retail customers.[244]

We retained the "personal, family, or household purposes" qualifier,[245] but are providing additional guidance and clarification on our interpretation of this phrase to address comments received. In particular, we interpret "personal, family or household purposes" to mean that *any* recommendation to a natural person for his or her account would be subject to Regulation Best Interest, other than recommendations to natural persons seeking these services for commercial or business purposes. Accordingly, under this interpretation, "personal, family or household purposes" would not include, for example, an employee seeking services for an employer or an individual who is seeking services for a small business or on behalf of another non-natural person entity such as a charitable trust.[246] As discussed above[247] and pursuant to the Care

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244 *See also* Relationship Summary Adopting Release.

245 Regulation Best Interest relies in part on the statutory authority provided in Section 913 of the Dodd-Frank Act which includes the statutory definition of "retail customer." *See* Section 913(a) of the Dodd-Frank Act.

246 As discussed below, to the extent a plan representative who decides service arrangements for a workplace retirement plan is a sole proprietor or other self-employed individual who will participate in the plan, the plan representative will be a retail customer to the extent that the sole proprietor or self-employed individual receives recommendations directly from a broker-dealer primarily for personal, family or household purposes.

247 *See supra* footnote 223 and accompanying text.

Obligation,[248] we believe broker-dealers are able to obtain sufficient facts to determine the purpose for which a recommendation will be used.

We also confirm that "personal, family or household purposes" would cover retirement accounts, as retirement savings is a personal, household or family purpose. Accordingly, the definition of retail customer will include a natural person receiving recommendations[249] for his or her own retirement account, including but not limited to IRAs and individual accounts in workplace retirement plans, such as 401(k) plans and other tax-favored retirement plans.[250] For

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248 Pursuant to the Care Obligation, a broker-dealer is required to ascertain the customer's investment profile which considers, among other things, financial situation and needs and investment objectives, in evaluating a recommendation and whether it is in a retail customer's best interest.

249 *See* Section II.C.2 (describing what constitutes a "recommendation" for purposes of Regulation Best Interest).

250 Such IRAs include, for example, individual retirement accounts and individual retirement annuities described by Internal Revenue Code section 408(a) and (b), "simplified employee pensions" (SEPs) described by Code section 408(k), and simple retirement accounts described by Code section 408(p) (SIMPLE IRAs). In response to commenters, we also clarify that workplace retirement plans include any arrangement available at a workplace that provides retirement benefits or allows saving for retirement, including, for example, any 401(k) plans or other plan that meet requirements for qualification under Code section 401(a), deferred compensation plans of state and local governments and tax-exempt organizations described by Code section 457, and annuity contracts and custodial accounts described by Code section 403(b). Likewise, the definition of retail investor includes natural persons seeking brokerage or advisory services for other tax-favored savings arrangements such as an Archer Medical Savings Account described by Code section 220(d), a Health Savings Accounts described by Code section 223(d) and any similar tax-favored health plan saving arrangement, a Coverdell education savings account described by Code section 530 and a qualified tuition program or "529 plan" established pursuant to Code section 529.

example, plan participants receiving recommendations about whether to take a distribution from a 401(k) plan or other workplace retirement plan and how to invest that distribution would be covered as retail customers. Similarly, a plan participant receiving recommendations for the participant's individual account held in a 401(k) plan or other workplace retirement plan would be a retail customer for purposes of Regulation Best Interest.[251]

The Commission acknowledges concerns from some commenters that workplace retirement plans and their representatives (e.g., plan sponsors, trustees, other fiduciaries) and service providers should be included in the definition of retail customer.[252] However, we understand that plan representatives of workplace retirement plans typically are not receiving recommendations for their own account for personal, family or household purposes when they engage a broker-dealer to provide services to a retirement plan established, maintained, and operated by an employer to provide pension or retirement savings benefits to employees; and further, as a legal representative of a plan participant, must comply with DOL rules.[253] As such,

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[251] For example, we understand that, although not common, some 401(k) plans and other individual account plans provide participants total discretion to choose a broker-dealer to provide services for their individual plan account. *See, e.g.*, 29 C.F.R. § 2550. 404c-1(f), Example 9.

[252] *See, e.g.,* ARA December 2018 Letter; FPC Letter. *But see* Empower Letter ("It would be helpful if the SEC could confirm that the definition of 'retail customer' under RBI does not include advice to managers of retirement plans or to their fiduciaries or representatives.").

[253] It is our understanding that the investment responsibilities of plan representatives typically include, among other things, selecting and monitoring a menu of plan

the Commission does not believe that workplace retirement plans or their representatives and

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investment options and designating and monitoring "default" investments for investing account balances of participants who do not make their own investment elections, and that plan representatives typically make these investment selections for a workforce with diverse investment profiles. *See* ARA December 2018 Letter (describing obligations of plan fiduciaries selecting an investment menu and qualified default investment alternatives); Empower Letter (describing plan fiduciary obligations to select investment menus). We also understand that plan representatives may receive brokerage and advice services for plans together with or complimentary with, other services supporting the plan's establishment, maintenance and operation, such as plan design, recordkeeping and other administrative services. *See, e.g.,* Groom Letter (describing business models of firms offering brokerage and advice services together with other services); SPARK Letter (same). In this context, a plan representative would not be receiving recommendations from a broker-dealer for his or her own account and considerations material to the plan representative's investment decisions differ from a situation in which a retail customer receives a recommendation from a broker-dealer for his or her own account.

Further, we note that DOL has rules currently in place (not affected by the Fifth Circuit's decision vacating the DOL Fiduciary Rule) that address how plan representatives operate participant-directed plans and select investment menus for such plans, *see* 29 CFR 2550.404c-1, what actions, including disclosures, plan representatives must take to be able to raise a defense or claim for investment losses by a participant or beneficiaries, *see* 29 CFR 2550.404c-5, and also generally require broker-dealers making investment alternatives available for a participant-directed plan to disclose in writing (among other things) all direct and indirect compensation received in connection with providing plan services. *See* 29 CFR 2550.408b-2(c). *See also* Form 5500, Schedule C, requiring after-the-fact reporting by certain plans of information regarding direct and indirect compensation received by, among others, broker-dealers and investment advisers, in connection with services rendered or their position with the plan.

Accordingly, we agree with those commenters who recommended that plan representatives should not be included in the definition of retail customer. *See* Empower Letter; Groom Letter; Letter from Nora M. Everett, President, Retirement and Income Solutions, Principal Financial Group (Aug. 7, 2018) ("Principal Letter"); SPARK Letter; T. Rowe Price Letter; Transamerica August 2018 Letter.

service providers generally fall within the definition of retail customer for purposes of Regulation Best Interest because the workplace retirement plan is not a natural person, and therefore the workplace retirement plan representatives are not a non-professional representative of a natural person that is receiving a recommendation directly from a broker-dealer for "personal, family, or household purposes."[254]

We note, however, that some plan representatives may participate under their employer's workplace plan, for example, in the case of a workplace IRA or other workplace retirement plan that is established and maintained by a sole proprietor or other self-employed individual that includes one or more employees in addition to the plan representative. To the extent that a plan representative who decides service arrangements for a workplace retirement plan is a sole proprietor or other self-employed individual who will participate in the plan, the plan representative would be a retail customer for purposes of Regulation Best Interest to the extent the sole proprietor or self-employed individual receives recommendations directly from a broker-dealer primarily for personal, family or household purposes.

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[254] Although workplace retirement plans are not generally covered by the definition of retail customer in by Regulation Best Interest, based on preliminary discussions with DOL staff, we understand that the DOL is considering regulatory options in light of the Fifth Circuit's decision vacating the DOL Fiduciary Rule, including the types of protections available to such workplace retirement plans and their representatives. Department of Labor Regulatory Agenda, Fiduciary Rule and Prohibited Transaction Exemptions, Fall 2018, *available at* https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201810&RIN=1210-AB82.

b. Retail Customer Use of the Recommendation

In the Proposing Release, the Commission did not specifically address whether recommendations subject to Regulation Best Interest needed to be for compensation, but did state that the proposed definition of retail customer would only apply to a person who "received a recommendation…from a broker or dealer or a natural person who is an associated person of a broker or dealer, and used the recommendation primarily for personal, family, or household purposes." We stated that this approach was appropriate because it builds upon the guidance provided for FINRA's suitability rule.[255] In response, a few commenters recommended that the Commission limit the application of Regulation Best Interest to recommendations made to retail customers for compensation.[256]

Regulation Best Interest applies to a retail customer that both *receives* a recommendation of any securities transaction or investment strategy involving securities by a broker-dealer and that *uses* that recommendation primarily for personal, family, or household purposes, and not simply those recommendations for which a broker-dealer receives compensation.[257] In response to commenters, we interpret that a retail customer "uses" a recommendation of a securities transaction or investment strategy involving securities when, as a result of the recommendation: (1) the retail customer opens a brokerage account with the broker-dealer, regardless of whether

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255 *See* Proposing Release at 21596, footnote 160.

256 *See* Morgan Stanley Letter; CCMC Letters.

257 *See* paragraph (b)(1) of Regulation Best Interest.

the broker-dealer receives compensation,[258] (2) the retail customer has an existing account with the broker-dealer and receives a recommendation from the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation, or (3) the broker-dealer receives or will receive compensation, directly or indirectly as a result of that recommendation, even if that retail customer does not have an account at the firm.[259]

When a retail customer opens or has an existing account with a broker-dealer the retail customer has a relationship with the broker-dealer and is therefore in a position to "use" (i.e., accept or reject) the broker-dealer's recommendation. In this context, tying "use" solely to a broker-dealer's receipt of compensation would inappropriately result in Regulation Best Interest

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[258] As discussed in Section II.B.2.b below, account recommendations, including recommendations of a securities account type generally, and recommendations to open an IRA or to roll over or transfer assets into an IRA, are covered by Regulation Best Interest regardless of whether those recommendations result in transactions or generate transaction-based compensation.

[259] *See* Proposing Release at 21596, footnote 160 and accompanying text. *See also* FINRA Regulatory Notice 12-55, Suitability – Guidance on FINRA's Suitability Rule (Dec. 2012) at Q6(b) ("The suitability rule would apply when a broker-dealer or registered representative makes a recommendation to a *potential investor* who then becomes a customer. Where, for example, a registered representative makes a recommendation to purchase a security to a *potential investor,* the suitability rule would apply to the recommendation if that individual executes the transaction through the broker-dealer with which the registered representative is associated or the broker-dealer receives or will receive, directly or indirectly, compensation as a result of the recommended transaction."); NASD Notice to Members 04-72, Transfers of Mutual Funds and Variable Annuities – Impermissible Use of Negative Response Letters for the Transfer of Mutual Funds and Variable Annuities (Changes in Broker-Dealer of Record) (Oct. 2004).

not applying to the broker-dealer's recommendations to hold securities positions or to maintain an investment strategy (such as account type), recommendations to open an account, or recommendations that may ultimately be rejected by the retail customer.

Whether the recommendation complies with Regulation Best Interest will be evaluated based on the circumstances that existed *at the time the recommendation was made* to the retail customer. Accordingly, broker-dealers should carefully consider the extent to which associated persons can make recommendations to prospective retail customers (i.e., that have received, but not yet "used" the recommendation as noted above) in compliance with Regulation Best Interest, including having gathered sufficient information that would enable them to comply with Regulation Best Interest at the time the recommendation is made, should the prospective retail customer use the recommendation.[260]

c. Conformity with Form CRS

The proposed definition of "retail customer" differed from the definition of "retail investor" proposed in the Relationship Summary Proposal, which was a prospective or existing client or customer who is a natural person (an individual), regardless of the individual's net worth, including a trust or other similar entity that represents natural persons.[261] The proposed definition was different from the definition of "retail investor" because the Relationship

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260 *See* FINRA Regulatory Notice 12-55 at Q6(b).

261 *See* Relationship Summary Proposal.

Summary was intended for an earlier state of the relationship between an investor and a financial professional, was intended to be required regardless of whether the investor would receive investment advice primarily for personal, family, or household purposes, and was designed to be delivered by investment advisers as well as broker-dealers.[262] Many commenters recommended that we use the same definition to facilitate compliance for firms and avoid investor confusion.[263]

The Commission agrees with commenters that using a similar definition would provide consistency in the protections, and ease the compliance burden, of the package of rulemakings. Therefore, the definitions in Form CRS and Regulation Best Interest have been revised to generally conform to each other, consistent with our respective goals in each of these rulemakings.[264] As discussed above, the definition of "retail customer" for purposes of Regulation Best Interest has been revised to apply only to natural persons, not all persons, in line with the definition of "retail investor" for purposes of Form CRS. In addition, the definition in Form CRS as adopted now includes the "personal, family or household purposes" qualifier.

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262 *See* Relationship Summary Proposal, Section II, footnote 29.

263 *See, e.g.,* Invesco Letter; BlackRock Letter; ICI Letter; Committee of Annuity Insurers Letter; Bank of America Letter; CFA August 2018 Letter; Cetera August 2018 Letter; Fidelity Letter; Morgan Stanley Letter; Oppenheimer Letter; Raymond James Letter; SIFMA August 2018 Letter; TIAA Letter; Transamerica August 2018 Letter.

264 *See* Relationship Summary Adopting Release.

While the definitions have generally been harmonized across the package of rulemakings,[265] they differ to reflect differences between the Relationship Summary delivery requirement and the obligations of broker-dealers under Regulation Best Interest, including that the Relationship Summary is required whether or not there is a recommendation and covers any prospective and existing clients and customers (i.e., a person who "seeks to receive or receives services") of investment advisers as well as broker-dealers.[266] For the reasons discussed in the Proposing Release and in response to commenters who requested clarification on whether Regulation Best Interest applies to prospective customers,[267] we would like to clarify that the definition of "retail customer" does not apply to prospective customers who do not receive and use recommendations from a broker-dealer,[268] as discussed above. This distinction reflects differences between the point in time the Relationship Summary is delivered to an investor and when the obligations of broker-dealers pursuant to Regulation Best Interest attach.

d. Treatment of Dual-Registrants

In the Proposing Release, the Commission stated that Regulation Best Interest applies only in the context of a brokerage relationship with a brokerage customer, and specifically, when

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265 *Id.*

266 *Id.*

267 *See, e.g.*, SIFMA August 2018 Letter; Prudential Letter; Money Management Institute Letter.

268 *See* Section II.B.3.b.

a broker-dealer is making a recommendation in the capacity of a broker-dealer. In particular, for dual-registrants (for purposes of this section, a broker-dealer that is dually registered as an investment adviser with the Commission), the obligations associated with Regulation Best Interest were intended to apply only when they are acting in the capacity as a broker-dealer.[269] The Commission recognized the issues surrounding the determination of whether a dual-registrant is acting in the capacity of a broker-dealer or an investment adviser, and asserted that such a determination requires a facts and circumstances analysis, with no one factor being determinative.[270]

Many commenters requested that the Commission clarify the treatment of dual-registrants and what is expected when offering products in both types of accounts.[271] Some commenters asserted that dually registered financial professionals should be held to a fiduciary standard.[272]

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269 Although this discussion focuses on the treatment of broker-dealers that are dually registered with the Commission as investment advisers, a broker-dealer should perform the same analysis when it is engaged in other financial services (such as, as a bank, a commodity trading advisor or a future commission merchant).

270 Proposing Release at 21596.

271 *See, e.g.,* SIFMA August 2018 Letter; CCMC Letters; NASAA August 2018 Letter.

272 *See* PIABA Letter; AICPA Letter.

A few commenters requested clarification on how Regulation Best Interest applies to particular scenarios, some of which involved dual-registrants.[273]

In response, the Commission is reaffirming the guidance provided in the proposal and providing further clarification on when and how Regulation Best Interest would apply to dual-registrants. As stated in the proposal, Regulation Best Interest would not apply to investment advice provided to a retail customer by a dual-registrant when acting in the capacity of an investment adviser, even if the retail customer has a brokerage relationship with the dual-registrant or the dual-registrant executes the transaction in its brokerage capacity.[274] Similarly, as proposed, we are confirming that a dual-registrant is an investment adviser solely with respect to those accounts for which a dual-registrant provides investment advice or receives compensation that subjects it to the Advisers Act.[275]

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273 *See* SIFMA August 2018 Letter; Letter from Michael Pieciak, NASAA President, Commissioner Vermont Department of Financial Regulation, NASAA (Feb. 19, 2019) ("NASAA February 2019 Letter").

274 This analysis would apply even if the dual-registrant receives transaction-based compensation for executing the transaction because the dual-registrant did not provide a recommendation in its capacity as a broker-dealer. While Regulation Best Interest would not apply in this situation, other provisions of the federal securities laws and SRO rules would apply to the actions taken or services provided by the broker-dealer.

275 *See* Proposing Release at 21596; *see also Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Exchange Act Release No. 51523 (Apr. 12, 2005) at 8 ("Release 51523"); Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, Advisers Act Release No. 2652 (Sep. 24, 2007). *See also* Fiduciary Interpretation.

While we acknowledge that some commenters believe all dual-registrants should be held to a fiduciary standard, for the reasons discussed in Section II.A, the Commission believes that Regulation Best Interest enhances the obligations that apply when a broker-dealer makes a recommendation to a retail customer by drawing from key principles underlying the fiduciary obligation that applies to investment advisers under the Advisers Act, while being tailored to the broker-dealer model.[276]

As stated in the proposal, determining the capacity in which a dual-registrant is making a recommendation is a facts and circumstances test, with no one factor being determinative, but the Commission considers, among other factors, the type of account, how the account is described, the type of compensation and the extent to which the dual-registrant made clear to the customer or client the capacity in which it was acting.[277]

In addition and in response to a commenter's presentation[278] of particular scenarios in its comment letter,[279] we would like to confirm or correct the commenter's understanding of Regulation Best Interest in practice to provide further guidance to firms as it relates to their

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276 *See* Section I.

277 Proposing Release at 21596.

278 *See* SIFMA August 2018 Letter. For purposes of the presented scenarios, SIFMA has assumed that the customer is a "retail customer."

279 *Id.*

examples of dual-registrants.[280] For example, in the commenter's explanation of a scenario related to a recommendation to open a fee-based account, we agree that Regulation Best Interest would not apply when a dually registered financial professional of a dually registered broker-dealer and investment adviser, who is acting in the capacity of an investment adviser, recommends a fee-based account. We note, however, that the dually registered financial professional would need to comply with the Advisers Act as well as the requirements with respect to Form CRS for the firm.[281] In response to another scenario in which a financial professional who is dually registered provides a holistic review of the overall performance of a family's accounts, which are both brokerage and advisory, whether Regulation Best Interest applies depends on a facts and circumstances analysis. Regulation Best Interest would apply if the financial professional in her brokerage capacity (disclosed pursuant to the Disclosure

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280 For purposes of this section, we have only addressed the scenarios applicable to dual-registrants and have not confirmed or rejected the commenter's analysis of the other scenarios.

281 *See* Fiduciary Interpretation at Section II.B.1. In providing advice about account type, the adviser should consider both types of accounts (i.e., brokerage and advisory accounts) when determining whether the advice is in the client's best interest. *See also* NASAA February 2019 Letter (stating that Regulation Best Interest would not apply but instead that the fiduciary duty under the Advisers Act would apply).

Obligation), provides a recommendation of a securities transaction or investment strategy involving securities to the family in the course of the holistic review.[282]

C. Component Obligations

As proposed Regulation Best Interest's 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" would have been satisfied by complying with four specified obligations: a Disclosure Obligation, a Care Obligation, and two Conflict of Interest Obligations.[283] Failure to comply with any of these proposed requirements would have violated Regulation Best Interest.[284]

As discussed above, we have determined to retain the overall structure and scope of the proposed rule, but are modifying and clarifying the component obligations that a broker-dealer must satisfy in order to meet the General Obligation. As adopted, the General Obligation is satisfied only if the broker-dealer complies with four specified component obligations: (1) the Disclosure Obligation; (2) the Care Obligation; (3) the Conflict of Interest Obligation; and (4) the Compliance Obligation. Each of these component obligations is discussed below. Whether a broker-dealer has acted in the retail customer's best interest under the General Obligation will

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282 *But see* NASAA February 2019 Letter (stating that "a full fiduciary duty" should be imposed on the financial adviser as to all accounts in this case as the family has probably entrusted their entire financial well-being to one financial professional).

283 Proposing Release at 21598.

284 *Id*.

turn on an objective assessment of the facts and circumstances of how these specific components of Regulation Best Interest are satisfied at the time that the recommendation is made (and not in hindsight). The specific component obligations of Regulation Best Interest are mandatory, and failure to comply with any of the components would violate Regulation Best Interest.

1. Disclosure Obligation

We proposed a Disclosure Obligation that would require a broker-dealer "to, prior to or at the time of [a] 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." The Proposing Release states that, for purposes of 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: (1) that the broker-dealer was acting in a broker-dealer capacity with respect to the recommendation; (2) fees and charges that would apply to the retail customer's transactions, holdings, and accounts; and (3) type and scope of services provided by the broker-dealer, including, for example, monitoring the performance of the retail customer's account.

As stated in the Proposing Release, we understand that broker-dealers typically provide information about their services and accounts, which may include disclosures concerning the broker-dealer's capacity, fees, services, and conflicts, on their firm websites and in their account

opening agreements.[285] Furthermore, while broker-dealers are subject to a number of specific disclosure obligations when they effect certain customer transactions, and are subject to the antifraud provisions of the federal securities laws, broker-dealers are not currently subject to an explicit and broad disclosure requirement under the Exchange Act regarding the scope and terms of the broker-dealer relationship.[286] To promote broker-dealer recommendations that are in the best interest of retail customers, we determined it was necessary to impose a more explicit and broader disclosure obligation on broker-dealers than that which currently exists under the federal securities laws and SRO rules.[287]

We solicited comment on the Disclosure Obligation and commenters addressed several aspects of this proposed obligation, including the interpretation of each required element, as discussed in the relevant sections below.[288] In consideration of these comments, we are revising the Disclosure Obligation to require a broker-dealer, prior to or at the time of the recommendation, to provide to the retail customer, in writing, full and fair disclosure[289] of all material facts related to the scope and terms of the relationship with the retail customer and all

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285 Proposing Release at 21599.

286 Proposing Release at 21599-21600.

287 Proposing Release at 21600.

288 *See, e.g.*, Better Markets August 2018 Letter; CCMC Letters; LPL August 2018 Letter; Schwab Letter; Morgan Stanley Letter; CFA August 2018 Letter; IPA Letter; NASAA Letter; SIFMA August 2018 Letter.

289 *See* Section II.C.1.c, Disclosure Obligation, Full and Fair Disclosure.

material facts relating to conflicts of interest that are associated with the recommendation.[290] We are explicitly requiring in the rule text the disclosure of examples in the Proposing Release of the "material facts relating to the scope and terms of the relationship with the retail customer:" (1) that the broker, dealer or such natural person is acting as a broker, dealer or an associated person of a broker-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.

The Disclosure Obligation requires the disclosure of *all* material facts related to the scope and terms of the relationship with the retail customer. The material facts identified in Regulation Best Interest are the minimum of what must be disclosed. Similar to what was proposed, broker-dealers will need to disclose in writing prior to or at the time of a recommendation any material facts that relate to the "scope and terms of the relationship." As to what constitutes a "material" fact related to the "scope and terms of the relationship," the standard for materiality for purposes of the Disclosure Obligation is consistent with the one the Supreme Court articulated in *Basic v. Levinson.*[291] Specifically, a fact is material if there is "a substantial likelihood that a reasonable

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290 As discussed in more detail below, aspects of the Disclosure Obligation may be satisfied by other regulatory requirements.

291 *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

shareholder would consider it important." In the context of Regulation Best Interest, the standard is the retail customer, as defined in the rule.

In response to comments, we are also refining and clarifying the treatment of conflicts of interest under Regulation Best Interest by: (1) generally consistent with the fiduciary duty under the Advisers Act, adopting for purposes of Regulation Best Interest, the definition of "conflict of interest" associated with a recommendation as "an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested";[292] and (2) revising the Disclosure Obligation to require disclosure of "material facts" relating to such conflicts of interest that are associated with the recommendation. Under this approach, all conflicts of interest as so defined will be covered by Regulation Best Interest (and thus, will be subject to the Conflict of Interest Obligation described below). However, only "material facts" regarding these conflicts of interest are required to be disclosed under the Disclosure Obligation.[293]

As discussed above, we are adopting a new set of disclosure requirements designed to reduce retail investor confusion in the marketplace for brokerage and advisory services and to

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[292] This is the same as the definition of "material conflict of interest" discussed in the Proposing Release but eliminates "material" and "a reasonable person would expect" for the reasons discussed below.

[293] The Conflict of Interest Obligation requires, among other things, that a broker-dealer establish written policies and procedures reasonably designed to identify and disclose all conflicts of interest associated with a recommendation. Such disclosure is required to be provided in accordance with the Disclosure Obligation. *See* Section II.C.3.d.

assist retail investors with the process of deciding whether to engage a particular firm or financial professional and whether to establish an investment advisory or brokerage relationship.[294] Specifically, we are requiring broker-dealers and investment advisers to deliver to retail investors a Relationship Summary.[295] The Relationship Summary will provide succinct information about the relationships and services the firm offers to retail investors, fees and costs that retail investors will pay, specified conflicts of interest and standards of conduct, and disciplinary history, among other things.[296] The Relationship Summary has a distinct purpose: it is intended to summarize information about a particular broker-dealer or investment adviser in a format that allows for comparability among the enumerated items, encourages investors to ask questions, and highlights additional sources of information.

As a general matter, the Relationship Summary reflects an initial layer of disclosure, with the Disclosure Obligation reflecting more specific and additional, detailed layers of disclosure.[297] We believe the Relationship Summary and the Disclosure Obligation, while separate obligations

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294 *See* Relationship Summary Adopting Release.

295 *See* Relationship Summary Adopting Release.

296 *See* Relationship Summary Adopting Release at Section I. For purposes of Form CRS, "retail investor" is defined as "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family, or household purposes."

297 Nevertheless, as discussed below where relevant, in some instances disclosures made pursuant to Form CRS may be sufficient to satisfy some aspects of the Disclosure Obligation.

with significant individual value, will 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 and may be required to be delivered at different times. In addition, we believe the Relationship Summary and Disclosure Obligation will improve the quality and consistency of disclosures and thus: (1) reduce the information asymmetry that may exist between a retail customer and their broker-dealer, and (2) facilitate customer comparisons of different broker-dealers which we expect will, in turn, increase competition among broker-dealers, including with respect to fees and costs.[298]

As discussed below, we have identified those items of information that we consider to be "material facts" under the Disclosure Obligation. Though there are disclosures in the Relationship Summary that could satisfy the Disclosure Obligation, in most instances the Relationship Summary will not be sufficient.[299] Moreover, as discussed below, we believe the Disclosure Obligation can be satisfied to varying degrees with existing documents provided to retail customers, such as account opening documents, with a standalone document, or by some combination. However, we encourage broker-dealers, in deciding whether to rely on such an existing disclosure document or whether to include or repeat information from existing

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298 *See infra* footnote 1192 and accompanying text.

299 For example, as noted below, a standalone broker-dealer will be able to satisfy the Disclosure Obligation's requirement to disclose the broker-dealer's capacity by delivering the Relationship Summary to the retail customer.

disclosures, to consider the usefulness and ease of understanding for retail customers of any existing disclosure document.

Oral Disclosure or Disclosure After a Recommendation

As discussed in more detail below, a number of commenters highlighted practical difficulties associated with delivering disclosure either in writing, or prior to or at the time of a recommendation in some instances. Although Regulation Best Interest requires that the Disclosure Obligation be made "in writing," we recognize the challenges associated with providing written disclosure in each instance that disclosure may be required. For example, a broker-dealer may need to supplement, clarify or update written disclosure it has previously made before or at the time it provides a customer with a recommendation. As we stated in the Proposing Release, we recognized that broker-dealers may provide recommendations by telephone and may need to offer clarifying disclosure orally in some instances subject to certain conditions, such as a dual-registrant informing a retail customer of the capacity in which the dual-registrant is acting in conjunction with a recommendation. We stated that a broker-dealer could orally clarify the capacity in which it is acting at the time of the recommendation if it had previously provided written disclosure to the retail customer beforehand disclosing its capacity as well as the method it planned to use to clarify its capacity at the time of the recommendation

Similarly, although Regulation Best Interest requires a broker-dealer to disclose, prior to or at the time of a recommendation, all material facts relating to the scope and terms of the relationship with the retail customer and relating to conflicts of interest that are associated with the recommendation, we recognize that in some instances a broker-dealer may not have all the material facts at the time of the recommendation, or that such disclosure is provided to the retail customer pursuant to an existing regulatory obligation, such as the delivery of a product

prospectus or a trade confirmation, after the execution of the trade.[300] In the Proposing Release we stated that in circumstances where a broker-dealer determines to provide an initial, more general disclosure (such as a relationship guide) followed by specific information in a subsequent disclosure that is provided after the recommendation (e.g., a trade confirmation) the initial disclosure should address when and how a broker-dealer would provide more specific information regarding the material fact or conflict in a subsequent disclosure (e.g., after the trade in the trade confirmation). We noted also that whether there is sufficient disclosure in both the initial disclosure and any subsequent disclosure would depend on the facts and circumstances.

We continue to believe that some flexibility with respect to the provision by broker-dealers of written and oral disclosure, as well as with respect to the timing that disclosure is made, is appropriate in certain circumstances, such as when a broker-dealer updates its written disclosures orally in order to reflect facts not reasonably known at the time the written disclosure is provided. In such circumstances, a broker-dealer may satisfy its Disclosure Obligation by making supplemental oral disclosure not later than the time of the recommendation, provided that the broker-dealer maintains a record of the fact that oral disclosure was provided to the retail customer.[301] In addition, in the limited instances where existing regulations permit disclosure after the recommendation is made (e.g., trade confirmation, prospectus delivery), a broker dealer

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300 *See infra* footnote 525.

301 *See* Section II.D, Record-Making and Recordkeeping.

may satisfy its Disclosure Obligation regarding the information contained in the applicable disclosure document by providing such document to the retail customer after the recommendation is made. Before supplementing, clarifying or updating written disclosures in the limited circumstances described above, broker-dealers must provide an initial disclosure in writing that identifies the material fact and describes the process through which such fact may be supplemented, clarified or updated.

For example, with regard to product-level fees, a broker-dealer could provide an initial standardized disclosure of product-level fees generally (e.g., reasonable dollar or percentage ranges), noting that further specifics for particular products appear in the product prospectus, which will be delivered after a transaction in accordance with the delivery method the retail customer has selected, such as by mail or electronically.[302] Similarly, with regard to the disclosure of a broker-dealer's capacity, a dual-registrant could disclose that recommendations will be made in a broker-dealer capacity unless otherwise expressly stated at the time of the recommendation, and that any such statement will be made orally. Or, a broker-dealer could disclose that its associated persons may have conflicts of interest beyond than those disclosed by

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[302] While using a percentage or dollar range to describe a fee can be appropriate, that range should be designed to reasonably reflect the actual fees to be charged. For example, if the firm offers in almost all instances funds with up-front sales charges of between 5% and 5.5%, but the disclosure states that mutual fund up-front sales charges may "range from 0.0% to 5.5%," then the broker-dealer would need to evaluate whether the disclosure should be revised to more accurately describe the sales charge. *See* discussion in Section II.C.1.a, Disclosure Obligation, Material Facts Regarding Scope and Terms of the Relationship, Fees and Costs, Particularly of Fees and Costs Disclosed.

the broker-dealer, and that associated persons will disclose, where appropriate, any additional material conflicts of interest not later than the time of a recommendation, and that any such disclosure will be made orally.

We believe it is in the public interest and consistent with the protection of investors to permit such flexibility in the delivery of information pursuant to the Disclosure Obligation. Providing retail customers written summary information about material facts relating to a recommendation and indicating that additional information will be forthcoming, the point at which the additional information will be delivered, and the method by which it will be conveyed, highlights for retail customers a useful summary of information while allowing for the practical realities of the process by which securities recommendations are made and transactions are executed and leaving longstanding existing disclosure regimes, particularly those relating to product issuer disclosure, undisturbed.

Other Liabilities Under the Federal Securities Laws

Further, the requirements under Regulation Best Interest that particular information be disclosed is not determinative of a broker-dealer or associated person's other potential liabilities under the general antifraud provisions of the federal securities laws for failure to disclose material information to a customer at the time of a recommendation.[303] In addition, we remind

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[303] 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 footnote 17 (1988) ("Silence, absent a duty to disclose, is

broker-dealers that even full and fair disclosure of the information required by the Disclosure Obligation is not sufficient, standing alone, to satisfy the Care Obligation, and that even sufficient disclosure cannot cure a violation of the Care Obligation.

Disclosures by Natural Persons Associated with a Broker-Dealer

The Disclosure Obligation applies to a broker, dealer, or natural person who is an associated person of a broker or dealer.[304] As stated in the Proposing Release, we are requiring

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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. 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."). 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 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, 130 (2d Cir. 2002); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970). *See* Proposing Release at 21599 footnote 176.

304 Rule 15*l*-1(a)(2)(i).

not only the broker-dealer entity, but also individuals who are associated persons of a broker-dealer (e.g., registered representatives) to comply with specified components of Regulation Best Interest when making recommendations to retail customers.[305] One commenter requested guidance on how an associated person should comply with the Disclosure Obligation.[306] In response, we believe that a natural person who is an associated person of a broker-dealer may in many instances rely on the disclosures provided by the broker-dealer with which he or she is associated to satisfy the Disclosure Obligation. However, when an associated person knows or should have known that the broker-dealer's disclosure is insufficient to describe "all material facts," the associated person must supplement that disclosure. For example, if an associated person of a broker-dealer that offers a full range of securities products is licensed solely as a Series 6 Registered Representative,[307] and can sell only mutual funds, variable annuities and other enumerated products, that limitation on the scope of services provided by the particular

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305 Proposing Release at 21592.

306 *See* NASAA August 2018 Letter (recommending that the Commission provide specific instructions on how associated persons should disclose capacity in which they are acting).

307 A candidate who passes the Series 6 exam is qualified for the solicitation, purchase and/or sale of the following securities products: Mutual funds (closed-end funds on the initial offering only), Variable annuities, Variable life insurance, Unit investment trusts (UITs), Municipal fund securities (*e.g.*, 529 savings plans, local government investment pools (LGIPs)). FINRA, Series 6 - Investment Company and Variable Contracts Products Representative Exam, Permitted Activities, *available at*: http://www.finra.org/industry/series6#permitted-activities.

associated person must be sufficiently clear in the broker-dealer's disclosures; otherwise additional clarifying disclosure by the associated person would be necessary.

a. Material Facts Regarding Scope and Terms of the Relationship

As discussed above, the proposed Disclosure Obligation would require a broker-dealer to, among other things, "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." We proposed to 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 was acting in a broker-dealer capacity with respect to the recommendation; (ii) fees and charges that would apply to the retail customer's transactions, holdings, and accounts; and (iii) the type and scope of services provided by the broker-dealer, including, for example, monitoring the performance of the retail customer's account.

Commenters requested that we clarify which facts a broker-dealer would be required to disclose about the scope and terms of the relationship it has with a customer under Regulation Best Interest.[308] In particular, several commenters recommended that the Commission clarify how a dual-registrant should disclose its capacity regarding its recommendations.[309] Other commenters recommended that the Commission define the scope of fees a broker-dealer must

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308 *See, e.g.,* SIFMA August 2018 Letter; Edward Jones Letter; NASAA August 2018 Letter; AARP August 2018 Letter; PIABA Letter; Prudential Letter.

309 *See, e.g.*, SIFMA August 2018 Letter; Edward Jones Letter.

disclose[310] and the form that disclosure should take.[311] In addition, some commenters requested clarity on the types of services that a broker-dealer would be required to disclose, including limitations on securities offered[312] and account monitoring services.[313]

As discussed below, in response to comments, we have revised the Disclosure Obligation to require disclosure of "all material facts relating to the scope and terms of the relationship with the retail customer, including: (i) that the broker, dealer or such natural person is acting as a broker, dealer or an associated person of a broker-dealer with respect to the recommendation; (ii) the material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and (iii) the type and scope of services provided to the retail customer, including any

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310 *See, e.g.*, Bank of America Letter (recommending that the Commission apply a "materiality" threshold to determine which fees should be disclosed).

311 *See, e.g.*, SIFMA August 2018 Letter (stating that a broker-dealer's disclosure of a range of customer costs per product should be sufficient); CFA August 2018 Letter (stating a broker-dealer's disclosure of percentages or ranges of cost information would do little to enlighten investors about the true costs of brokers' advice services).

312 *See, e.g.*, NY Life Letter (stating that an insurer may appropriately focus its career agents on the distribution of variable insurance products that the insurer manufactures, so long as limitations on the universe of available products are disclosed to consumers and supervisory procedures are in place to ensure that a variable insurance product is in the client's best interest); CFA Institute Letter (stating that the Disclosure Obligation should complement the information presented in Form CRS and provide greater specificity about, among other things, the type and scope of services offered by the broker-dealer).

313 *See, e.g.,* IAA August 2018 Letter (recommending that the Commission clarify that Regulation Best Interest would apply to all advisory activities that broker-dealers agree to provide (*e.g.*, ongoing monitoring for purposes of recommending changes in investments)).

material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer."[314] In addition, we are clarifying the scope of the obligation.

As we did in the Proposing Release, we emphasize that although we have explicitly identified the capacity in which the broker-dealer is acting, material fees and costs, and the type and scope of services, as what would at a minimum be required to be disclosed as "material facts relating to the scope and terms of the relationship with the retail customer," the Disclosure Obligation requires broker-dealers and associated persons to disclose "*all* material facts relating to the scope of the terms of the relationship," (emphasis added) and broker-dealers and such associated persons thus will need to consider, 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 need to be disclosed. This analysis generally should include consideration of whether information in the Relationship Summary constitutes a "material fact" that could appropriately be expanded upon in satisfying the Disclosure Obligation. It would be possible, but would be unlikely for most broker-dealers, for the abbreviated format of the Relationship Summary to sufficiently disclose "all material facts" regarding the scope and terms of the relationship such that no further information would be required to satisfy the Disclosure Obligation.

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[314] Rule 15*l*-1(a)(2)(i)(A).

Capacity In Which the Broker-Dealer is Acting

In the Proposing Release, the Commission identified that the capacity in which a broker-dealer is acting is a material fact relating to the scope and terms of a customer relationship subject to the Disclosure Obligation.[315] In so identifying this critical element of information, we hoped to promote greater awareness among retail customers of the capacity in which their financial professional or firm acts with respect to recommendations.

Several commenters requested additional guidance on how dual-registrants and their associated persons could comply with the proposed Disclosure Obligation in this respect.[316] Some commenters stated that repeated disclosures of capacity would distract customers from more important disclosures related to a recommendation and could lead to confusion.[317] While we received comments expressing concerns that our proposed approach might lead to investor

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315 Proposing Release at 21601.

316 *See, e.g.,* NASAA August 2018 Letter (requesting that the Commission provide guidance to associated persons of dual-registrants explaining how they should disclose the capacity in which they are acting and whether they are providing a recommendation or advice); Better Markets August 2018 Letter; CFA August 2018 Letter; Fidelity Letter; IPA Letter; SIFMA August 2018 Letter; Edward Jones Letter; CCMC Letters.

317 *See, e.g.,* Edward Jones Letter (recommending that the Commission not require repeated capacity disclosures to customers because it would be redundant and potentially confuse customers); SIFMA August 2018 Letter (stating that disclosure of capacity should not be required at the time of the recommendation as it would cause unnecessary delay and distract customers from more important disclosures regarding account features and recommendations); Better Markets August 2018 Letter (stating that one-time written disclosure about a dual-registrant's advisory capacity, followed by future oral disclosures when they change roles when making recommendations would be confusing).

confusion,[318] many of these commenters were seeking clarity regarding this requirement and not its elimination.[319]

In response to commenters, we are revising Regulation Best Interest to explicitly require disclosure of capacity, which the Proposing Release addressed in guidance. Therefore, Rule 15*l*-1(a)(2)(i)(A) requires that 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, provide the 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, including that the broker-dealer or such natural person is acting as a broker-dealer or an associated person of a broker-dealer with respect to the recommendation.

This disclosure is designed to improve awareness among retail customers of the capacity in which their financial professional or broker-dealer acts when it makes recommendations so that the retail customer can more easily identify and understand their relationship, a goal shared

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318 *See, e.g.*, Better Markets August 2018 Letter; CFA August 2018 Letter (stating that flexibility in disclosure will result in disclosures that do not effectively convey key information especially for dual-registrants as customers will not understand the capacity the dual-registrant is acting in at the particular time or its significance).

319 *See, e.g.*, SIFMA August 2018 Letter (requesting that the Commission clarify the application of the Disclosure Obligation to dually registered firms and personnel, including what, and how frequently, disclosure is required to put customer on notice of their capacity); Edward Jones Letter; IPA Letter; CCMC Letters.

with the Relationship Summary.[320] Form CRS requires a firm to state the name of the broker-dealer or investment adviser and whether the firm is registered with the Commission as a broker-dealer, investment adviser, or both.[321] A standalone broker-dealer (i.e., a broker-dealer not also registered as an investment adviser) will generally be able to satisfy the Disclosure Obligation's requirement to disclose the broker-dealer's capacity by delivering the Relationship Summary to the retail customer.

For broker-dealers who are dually registered, and for associated persons who are either dually registered or, who are not dually registered but only offer broker-dealer services through a firm that is dually registered, the information contained in the Relationship Summary will not be sufficient to disclose their capacity in making a recommendation. Although some commenters expressed concerns about potential investor confusion caused by "additional" disclosure regarding a dual-registrant's capacity, we believe that the Disclosure Obligation will not duplicate or confuse, but instead will provide clarifying detail on capacity to supplement the information contained in the Relationship Summary. Accordingly, we are clarifying that dually registered associated persons and associated persons who are not dually registered but only offer broker-dealer services through a firm that is dually registered as an investment adviser with the Commission or with a state, must disclose whether they are acting (or, in the case of the latter,

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320 *See* Relationship Summary Proposal at 21420.

321 *See* Relationship Summary Adopting Release at Section II.C.

that they are only acting) as an associated person of a broker-dealer to satisfy the Disclosure Obligation.[322] An associated person of a dual-registrant who does not offer investment advisory services must disclose that fact as a material limitation in order to satisfy the Disclosure Obligation.

Furthermore, as discussed in greater detail below, we would presume the use of the terms "adviser" and "advisor" by (1) a broker-dealer that is not also registered as an investment adviser or (2) a financial professional that is not also a supervised person of an investment adviser to be a violation of the Disclosure Obligation under Regulation Best Interest. Disclosure of capacity may, in part, be made orally under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*. For example, a broker-dealer may disclose that: "All recommendations will be made in a broker-dealer capacity unless otherwise expressly stated at the time of the recommendation; any such statement will be made orally." In this case, no further oral or written disclosure would be required until a recommendation is made in a capacity other than as a broker-dealer. Similarly, a broker-dealer may disclose that: "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

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[322] Financial professionals with registrations to offer services as a representative of a broker-dealer and investment adviser may offer services through a dual-registrant, affiliated firms, or unaffiliated firms, or only offer one type of service notwithstanding their dual licensing. Financial professionals who are not dually registered may offer one type of service through a firm that is dually registered. *See* Relationship Summary Adopting Release at Section II.B.4.

we make a recommendation to you, we will expressly tell you orally which account we are discussing"). In this instance, no further disclosure of capacity is necessary.

Capacity in the Context of Names, Titles, and Marketing Practices

The Relationship Summary Proposal included a proposed rule that would have restricted broker-dealers and their associated persons (unless they were registered as, or supervised persons of, an investment adviser), when communicating with a retail investor, from using the term "adviser" or "advisor" as part of a name or title ("Titling Restrictions").[323] After further consideration of our policy goals and the comments we received, and in light of the disclosure requirements under Regulation Best Interest, we do not believe that adopting a separate rule restricting these terms is necessary, because we presume that the use of the term "adviser" and "advisor" in a name or title by (1) a broker-dealer that is not also registered as an investment adviser or (2) an associated person that is not also a supervised person of an investment adviser, to be a violation of the capacity disclosure requirement under the Disclosure Obligation as discussed further below.[324]

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323 *See* Relationship Summary Proposal, *supra* footnote 12, at 21461–63. We also requested comment on whether we should explicitly restrict other terms, including "wealth manager" and "financial consultant." Additionally, we requested comment on whether we should restrict terms that are synonymous with "adviser" or "advisor."

324 We recognize that, in adopting the fee-based brokerage rule in 2005, we declined to place any limitations on how a broker-dealer may hold itself out or the titles it may employ. *Certain Broker-Dealers Deemed Not to Be Investment Advisers*, Advisers Act Release No. 2376 (Apr. 12, 2005). However, as we noted in the Relationship Summary Proposal, comments we received in response to Chairman Clayton's request for comment and our

We received several comments on the proposed Titling Restrictions, which we have also considered when determining to presume use of such names and titles to be a violation of the capacity disclosure.[325] Some commenters supported a restriction on the terms "adviser" and "advisor," noting, for example, that these particular terms are often associated with the statutory term "investment adviser,"[326] or that investors "typically associate" these terms with registered

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experience prompted us to revisit our approach from 2005. In addition, given that the new disclosure requirements under Regulation Best Interest and Form CRS will and should necessitate a reassessment of a broker-dealer's names, titles, and communications with its customers, we believe it is necessary to re-evaluate the appropriateness of these practices in light of these new obligations. *See also generally* Relationship Summary Proposal, *supra* footnote 12, at 21459–61 (citing commenters and studies by the Siegel and Gale Consulting Group and the RAND Corporation that document investor confusion in the marketplace, all of which were conducted subsequent to the 2005 fee-based brokerage rule); Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers, Chairman Jay Clayton (Jun. 1, 2017), *available at* https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31. We also proposed rules (the "Affirmative Disclosures") that would have required a broker-dealer and an investment adviser to prominently disclose that it is registered as a broker-dealer or investment adviser, as applicable, with the Commission in print or electronic retail investor communications. As we discuss in a concurrent rulemaking, we are not adopting the Affirmative Disclosures. *See* Relationship Summary Adopting Release, *supra* footnote 12, at Section III.

325 *See*, *e.g.,* CFA August 2018 Letter; IAA August 2018 Letter; LPL August 2018 Letter; Letter from Dennis M. Kelleher, President and CEO, et al., Better Markets (Aug. 7, 2018) ("Better Markets CRS Letter").

326 *See* Letter from Lexie Pankratz, Owner, Trailhead Consulting, LLC (Aug. 7, 2018) ("Trailhead Letter").

investment advisers.[327] A few commenters generally noted that the title "financial advisor" prevents investors from understanding whether they are engaging a financial professional who provides advisory services or who sells brokerage services.[328] Moreover, other commenters generally stated that names and titles containing "adviser" or "advisor" create investor confusion and/or could mislead investors about the differences between broker-dealers and investment advisers including the applicable standard of care[329] and the services to be provided.[330]

Other commenters did not support the proposed Titling Restrictions, believing that the terms "adviser" and "advisor" are more generically used and understood, and refer to financial professionals who provide advice and financial services more generally.[331] Several of these

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327 *See*, *e.g.*, Letter from Kurt N. Schacht, Managing Director, et al., CFA Institute (Aug. 7, 2018) ("CFA Institute CRS Letter"); Pickard Letter.

328 *See, e.g.*, Letter from Gerald Lopatin (Jul. 30, 2018) ("Lopatin Letter"); Letter from Paula Hogan (Aug. 6, 2018) ("Hogan Letter"); Letter from Arlene Moss (Jul. 31, 2018) ("Moss Letter"); Letter from Daniel Wrenne (Jul. 31, 2018) ("Wrenne Letter").

329 *See, e.g.,* FSI August 2018 Letter; Schwab Letter; CFA Institute CRS Letter; Betterment Letter.

330 *See, e.g.,* NASAA August 2018 Letter (stating that "[t]his rule change will help forestall retail investors' confusion about the different roles and duties owed by broker-dealers/agents and investment advisers/investment adviser Representatives"); CFA Institute CRS Letter (stating that "[i]nvestor confusion about the roles and duties of different financial services providers who use "adviser/advisor" in their titles has become problematic from both an investor protection and trust standpoint. Use of the proposed CRS, alone, will not allay the substantial investor confusion in the marketplace about the differences between broker-dealers and investment advisers.")

331 *See* LPL August 2018 Letter (stating that "restricting use of 'advisor' and 'adviser' is contrary to the plain English meaning the average investor associates with those terms …

commenters stated that the restriction adds little additional investor protection when taken together with Regulation Best Interest and Form CRS (i.e., it is duplicative).[332] Additionally, some commenters stated that Form CRS alone provides similar investor protections that alleviate the need for the restriction.[333] Along similar lines, one commenter stated that certain fraud-based securities laws and FINRA rules provide the same protections that the proposed restriction seeks to add, making it unnecessary.[334]

We also received several comments on the following alternative approaches to the Titling Restrictions on which we sought comment: (i) a broker-dealer that used the terms "adviser" or "advisor" as part of a name or title would not be considered to provide investment advice solely incidental to the conduct of its business as a broker-dealer, and (ii) a broker-dealer would not be providing investment advice solely incidental to its brokerage business if it "held itself out" as an

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regardless of the legal contours of the service relationship."); NAIFA Letter (stating that "[m]any financial professionals are recognized as and/or refer to themselves as 'advisors/advisers' or 'financial advisors/advisers.' These words are (aptly) used by professionals who offer advice on any number of financial topics."); Letter from Investments & Wealth Institute ("IWI") (Aug. 6, 2018) ("IWI August 2018 Letter") (stating that an outright ban on the use of the terms "adviser" and "advisor" by broker-dealers would raise First Amendment concerns).

332 *See*, *e.g.,* Letter from Robert D. Oros, Chief Executive Officer, HD Vest Financial Services (Aug. 7, 2018) ("HD Vest Letter"); LPL August 2018 Letter; SIFMA August 2018 Letter. *But see* Pickard Letter (supporting the restriction and our proposed alternative holding out approach by noting that "[w]e do not think that Reg BI or Form CRS as currently proposed is sufficient.")

333 *See*, *e.g.*, LPL August 2018 Letter; Morgan Stanley Letter; Raymond James Letter.

334 *See* Cambridge Letter.

investment adviser to retail investors.[335] This second alternative approach would have resulted in a restriction generally broader in scope than the Titling Restrictions, as it would also have encompassed communications and sales practices in addition to the use of names and titles.

In response to these alternatives, several commenters stated that the Titling Restrictions were too narrow in meeting the Commission's intended objective of mitigating the risk that investors could be misled by the use of certain names and titles because the Titling Restrictions did not address other confusing names or titles,[336] and, more specifically, because the Titling

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335 *See* Relationship Summary Proposal, *supra* footnote 12, at 21463–64. We are not adopting the proposed alternative approach that would have restricted a broker-dealer from availing itself of the solely incidental exclusion if it "held itself out" as an investment adviser. Use of the terms "adviser" or "advisor," however, could support a conclusion depending on other facts and circumstances, that the primary business of the firm is advisory in nature, in which case the advice provided by the broker-dealer would not be solely incidental to the conduct of its brokerage business. *See* Solely Incidental Interpretation, *supra* footnote 12, at Section II.B (providing the Commission's interpretation of the solely incidental prong of the broker-dealer exclusion from the Advisers Act).

336 *See e.g.*, Letter from Barbara Roper, Director of Investor Protection, and Micah Hauptman, Financial Services Counsel, (Dec. 7, 2018) ("CFA December 2018 Letter"); State Treasurers Letter; Waters Letter (noting that the Titling Restrictions are too narrow of a fix for investor confusion because they fail "to address the numerous other titles professionals use…. As a result, most retail investors cannot easily distinguish between financial advisers who are mere salespeople and those that are investment advisers that must provide advice that is in the best interests of the investor."). *See also* NAIFA Letter (noting that restricting these terms for broker-dealers and their financial professionals only "and not for numerous other professionals using those words and delivering advice on a wide variety of financial topics creates more consumer confusion and does not enhance consumers' understanding of the specific obligations and standards that apply to their advisor(s).")

Restrictions did not address the broker-dealers who "hold themselves out" as investment advisers.[337] Several of these commenters instead advocated for precluding reliance on the solely incidental prong by any broker-dealer that holds itself out as an investment adviser.[338] Some commenters stated that certain marketing practices indicate that advice is the main function of the broker-dealer's service.[339] Additionally, one commenter stated that "the potential for

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Additionally, several of the commenters who supported the restriction recommended modifications such as broadening the restriction to include other terms, including "wealth manager" and "financial consultant." *See*, *e.g.*, Financial Engines Letter; Comment Letter of Altruist Financial Advisors LLC (Aug. 7, 2018) ("Altruist Letter"); Letter from David John Marotta (April 22, 2018) ("Marotta Letter"); Galvin Letter; Letter from Pamela Banks, Senior Policy Counsel, Consumers Union (Oct. 19, 2018) ("Consumers Union Letter").

337 *See, e.g.*, CFA August 2018 Letter; FPC Letter; IAA August 2018 Letter; Letter from Michael Kitces (Aug. 2, 2018) ("Kitces Letter"); LPL August 2018 Letter; MarketCounsel Letter; Waters Letter.

338 *See*, *e.g.*, IAA August 2018 Letter (noting that "[w]hile names or titles are contributing factors to investor confusion and the potential for investors to be misled, we believe that other factors should be considered as well. In particular, previous studies noted the confusion arising from 'we do it all' advertisements and 'marketing efforts which depicted an ongoing relationship between the broker-dealer and the investor.'"); Betterment Letter; CFA August 2018 Letter; LPL August 2018 Letter.

339 *See* CFA August 2018 Letter (citing to Micah Hauptman and Barbara Roper, Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways, January 18, 2017). *See also* Better Markets CRS Letter (stating that titles present a professional as not "only an expert in financial matters but also someone who will offer advice and recommendations"); Letter from Michael Palumbo (Aug. 7, 2018) ("Palumbo Letter"); Kitces Letter.

investor confusion is at its greatest when dealing with broker-dealers and dual-registrants that routinely market their services as advisory in nature…."[340]

Use of Terms "Adviser" or "Advisor"

Financial firms and their professionals, including broker-dealers and investment advisers, seek to acquire new customers and to retain existing customers by marketing their services, including through the use of particular terms in names and titles. Firms often spend time and money to market, brand, and create intellectual property by using these terms in an effort to shape investor expectations.[341] A name or title is generally used, and is designed to have significance, on its own without any additional context as to what it means. Given that the titles "adviser" and "advisor" are closely related to the statutory term "investment adviser," their use by broker-dealers can have the effect of erroneously conveying to investors that they are regulated as investment advisers, and have the business model, including the services and fee

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340 *See* CFA August 2018 Letter. *See also* CFA Institute CRS Letter (stating that the proposal should address "those who may not expressly refer to themselves as 'adviser/[advis]or' but through their actions convey that meaning to investors….").

341 *See*, *e.g.*, Letter from Barbara Roper, Director of Investor Protection, and Micah Hauptman, Financial Services Counsel, CFA (Sep. 14, 2017) ("CFA September 2017 Letter") ("[O]ur study documents how everything from the titles brokers use to the way they describe their services is designed to send the message that they are in the business of 'providing expert investment advice, comprehensive financial planning, and retirement planning that is based on their clients' needs and goals and that is designed to serve their best interests.'")

structures, of an investment adviser.[342] Such potential effect undermines the objective of the capacity disclosure requirement under Regulation Best Interest to enable a retail customer to more easily identify and understand their relationship.

As discussed above, the Disclosure Obligation requires broker-dealers to make full and fair disclosure of all material facts relating to the scope and terms of the relationship with a retail customer, including the capacity in which they are acting with respect to a recommendation. The capacity disclosure requirement is designed to improve awareness among retail customers of the capacity in which their firm and/or financial professional acts when it makes recommendations so that a retail customer can more easily identify and understand their relationship.[343] We believe that in most cases broker-dealers and their financial professionals cannot comply with the capacity disclosure requirement by disclosing that they are a broker-dealer while calling themselves an "adviser" or "advisor." Under the Disclosure Obligation, a broker-dealer, or an associated person, must, prior to or at the time of the recommendation, disclose that the broker-dealer or that associated person is acting as a broker or dealer with respect to the

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342 *See* Relationship Summary Proposal, *supra* footnote 12, at 21461.

343 Similarly, Form CRS is designed to reduce retail investor confusion in the marketplace for brokerage and investment advisory services and to assist retail investors with the process of deciding whether to engage, or to continue to engage, a particular firm or financial professional and whether to establish, or to continue to maintain, an investment advisory or brokerage relationship. A broker-dealer firm or financial professional's use of "adviser" or "advisor" in its name or title would inhibit a customer's full understanding of the contours of his or her relationship with the firm and financial professional, undermining Form CRS.

recommendation.[344] When a broker-dealer or an associated person uses the name or title "adviser" or "advisor" there are few circumstances[345] in which that broker-dealer or associated person would not violate the capacity disclosure requirement because the name or title directly conflicts with the information that the firm or professional would be acting in a broker-dealer capacity.[346] Therefore, use of the titles "adviser" and "advisor" by broker-dealers and their financial professionals would undermine the objectives of the capacity disclosure requirement by potentially confusing a retail customer as to type of firm and/or professional they are engaging, particularly since "investment adviser" is defined by statute separately from "broker" or "dealer."

As a result,[347] we presume that the use of the terms "adviser" and "advisor" in a name or title by (i) a broker-dealer that is not also registered as an investment adviser or (ii) an associated

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344 *See* Rule 15*l*-1(a)(2)(i)(A)(i).

345 *See infra* footnotes 349-351 and accompanying text.

346 In the Relationship Summary Proposal, we stated that our proposed restriction on the terms "adviser" and "advisor" would not have applied to broker-dealers when communicating with institutions. *See* Relationship Summary Proposal, *supra* footnote 12, at 21462. Given that Regulation Best Interest and the Relationship Summary apply only to retail customers and retail investors, respectively, our presumption would only apply to the use of "adviser" and "advisor" in such contexts. Therefore, we do not believe that further clarification of communications by non-retail focused broker-dealers is necessary.

347 Specifically, in the Proposing Release we stated that a standalone broker-dealer would satisfy the capacity disclosure by complying with the proposed Relationship Summary and Affirmative Disclosure requirements. We provided this proposed guidance in the context of concurrently proposing the Titling Restrictions. For the reasons discussed herein, we believe a presumption against the use of these titles by standalone broker-dealers is more appropriate than a restriction.

person that is not also a supervised person of an investment adviser to be a violation of the capacity disclosure requirement under Regulation Best Interest.[348]

Although using these names or titles creates a presumption of a violation of the Disclosure Obligation in Regulation Best Interest, we are not expressly prohibiting the use of these names and titles by broker-dealers because we recognize that some broker-dealers use them to reflect a business of providing advice other than investment advice to retail clients. A clear example is a broker-dealer (or associated person) that acts on behalf of a municipal advisor[349] or commodity trading adviser,[350] or as an advisor to a special entity,[351] as these are distinct advisory roles specifically defined by federal statute that do not entail providing investment advisory services. We also recognize that a broker-dealer may provide advice in other capacities outside

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348 If a financial professional is a registered representative of a broker-dealer that is a dual-registrant but the professional is not also a supervised person of an investment adviser, this professional would similarly be presumptively in violation of the capacity disclosure requirement if the financial professional uses the title "adviser" or "advisor." However, this financial professional may continue to use either the dual-registrant's materials or may use the firm's name in the financial professional's communications even if the firm's name includes the title "adviser" or "advisor" because such firm is dually registered as an investment adviser and broker-dealer and is not presumptively violating the capacity disclosure requirement under Regulation Best Interest. Moreover, we believe it would be consistent for dual-registrants and dually registered financial professionals to use these terms as they would be accurately describing their registration status as an investment adviser.

349 15 U.S.C. 78o-4(e)(4).

350 15 U.S.C. 80b-2(a)(29).

351 15 U.S.C. 78o-8(h)(2)(A).

the context of investment advice to a retail customer that would present a similarly compelling claim to the use of these terms. In these circumstances, firms and their financial professionals may in their discretion use the terms "adviser" or "advisor."[352] In most instances, however, when a broker-dealer uses these terms in its name or title in the context of providing investment advice to a retail customer, they will generally violate the capacity disclosure requirement under Regulation Best Interest.

Marketing Communications

As discussed above, several commenters on the Titling Restrictions raised concerns that restricting the use of names and titles would be insufficient to address what they viewed as the larger issue of broker-dealer marketing communications where a broker-dealer and/or its financial professional appears to be holding itself out as an investment adviser. Marketing

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352 Some commenters raised concerns that the proposed restriction would not permit financial professionals to indicate that they maintain particular certifications that include in the name or title "adviser" or "advisor." *See*, *e.g.*, IWI August 2018 Letter; Letter from IWI (Oct. 9, 2018) ("IWI October 2018 Letter"). *Cf.* Letter from John Robinson (Aug. 6, 2018) ("Robinson Letter") (suggesting that the Commission limit the use of the term "financial planner" to investment adviser representatives); FPC Letter (suggesting that the Commission clarify which certifications or professional designations may be used for financial planners). We recognize that these designations are intended to convey adherence to particular standards that financial professionals have met. However, these designations are not rooted in any statutory construct (as are the titles "commodity trading advisor" and "municipal advisor") and given that the terms "adviser" and "advisor" are still associated with the statutory term "investment adviser," even if used in a designation, a broker-dealer or associated person that uses these designations would similarly be in presumptive violation of the capacity disclosure requirement in Regulation Best Interest.

communications provide additional context to investors and are designed to persuade potential customers to obtain and pay for the firm's services and products.[353] They communicate to customers what services firms understand themselves to be providing—including, for broker-dealers, recommendations in connection with and reasonably related to effecting securities transactions.

The way in which a broker-dealer markets itself may have regulatory consequences. As noted above, Form CRS requires, among other items, broker-dealers (and investment advisers) to state clearly key facts about their relationship, including their registration status and the services they provide.[354] Broker-dealers (and investment advisers) will also be required through Form CRS to provide information to assist retail investors in deciding whether to engage in an

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353 Affiliated firms may market advisory and brokerage services in a single set of communications. A dually registered firm also may seek to market the primary services provided by its advisory and brokerage business lines in a single set of communications. We believe this combined approach to providing customers with information about investment services enhances customer choice, and we understand that many such firms market in this way in an effort to provide a comprehensive picture of the firm's services.

See also Instructions to Form CRS, General Instruction 5. (Encouraging dual-registrants to prepare one relationship summary discussing both its brokerage and investment advisory services, but stating that they may prepare two separate relationship summaries for brokerage services and investment advisory services. Whether the firm prepares one relationship summary or two, the firm must present the brokerage and investment advisory information with equal prominence and in a manner that clearly distinguishes and facilitates comparison of the two types of services.).

354 *See* Relationship Summary Adopting Release, *supra* footnote 12.

investment advisory or brokerage relationship.[355] Additionally and as discussed above, we are adopting the capacity disclosure requirement under Regulation Best Interest, which requires broker-dealers and their financial professionals to affirmatively disclose the capacity (e.g., brokerage) in which they are acting with respect to their recommendations.[356] These obligations are designed to improve awareness among retail customers of the capacity in which their firm or financial professional acts when it makes recommendations so that the retail customer can more easily identify and understand their relationship.

As noted above, we are not adopting the Commission's proposed alternative holding out approach that would have addressed broker-dealer marketing communications through the lens of the solely incidental exclusion.[357] However, under our interpretation of the solely incidental prong of the broker-dealer exclusion from the definition of investment adviser, a broker-dealer's investment advisory services do not fall within that prong if the broker-dealer's primary business is giving investment advice or if its investment advisory services are not offered in connection with and are not reasonably related to the broker-dealer's business of effecting securities transactions.[358] By more clearly delineating when a broker-dealer's performance of advisory

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355 *Id.*

356 *See* Rule 15*l*-1(a)(2)(i)(A)(i).

357 *See supra* footnote 335 and accompanying text.

358 *See* Solely Incidental Interpretation, *supra* footnote 12, Section II.B (providing the Commission's interpretation of the solely incidental prong of the broker-dealer exclusion from the Advisers Act.)

activities renders it an investment adviser, this interpretation provides guidance that may be informative to broker-dealers when designing marketing communications that accurately reflect their activities.

Broker-dealers, dual-registrants, and affiliated broker-dealers of investment advisers that market their services together should consider whether modifications are needed in their marketing communications in light of these new obligations. As we noted in the Relationship Summary Proposal, broker-dealers can, and do, provide investment advice so long as such advice comports with the broker-dealer exclusion under Advisers Act section 202(a)(11)(C). While broker-dealers and their financial professionals may state that they provide "advice" in their marketing communications, those and other statements should not be made in a manner that contradicts the disclosures made pursuant to Regulation Best Interest and Form CRS, and should be reviewed in light of the Solely Incidental Interpretation.[359] We believe that the combination of new disclosure obligations and requirements and firms' implementation of these new obligations will appropriately address commenters' concerns regarding broker-dealers that hold themselves out as investment advisers, particularly those who can change capacities when serving retail investors in a dual capacity.[360]

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359 *See* Relationship Summary Proposal, *supra* footnote 12, at 21461.

360 *See*, *e.g.*, IAA August 2018 Letter; FPC Letter; Better Markets CRS Letter.

In addition to these new obligations, FINRA Rule 2210 (regarding its members' communications with the public) is designed to ensure that broker-dealer communications with the public are fair, balanced, and not misleading.[361] This rule includes general standards, such as a requirement to not make any false or misleading statements, and specific content standards, such as requirements on how to disclose the broker-dealer's name in marketing communications.[362] Accordingly, we anticipate that FINRA will be reviewing the application of these rules in light of these new disclosure obligations. The Commission staff also will evaluate broker-dealer marketing communications to consider whether additional measures may be necessary.

Fees and Costs

In the Proposing Release, we stated that fees and charges applicable to the retail customer's transactions, holdings, and accounts would also be examples of "material facts relating to the terms and scope of the relationship"[363] As such, these fees and charges would generally have needed to be disclosed in writing prior to, or at the time of, the recommendation.

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361 *See* FINRA Rule 2210.

Additionally, broker-dealers and their financial professionals should keep in mind the applicability of the antifraud provisions of the federal securities laws, including section 17(a) of the Securities Act, and Exchange Act Section 10(b) and Rule 10b-5 thereunder, to their marketing practices.

362 *See*, *e.g.*, FINRA Rule 2210(d)(1) and (d)(3).

363 *See* Proposing Release at 21601.

While we did not propose to mandate the form, specific content, or method for delivering fee disclosure, we stated that we would generally expect that, to meet the Disclosure Obligation, broker-dealers would build upon the proposed Relationship Summary by disclosing, among other things, additional detail regarding the types of fees and charges described in the proposed Relationship Summary.[364]

We received a number of comments on the proposed Disclosure Obligation relating to fees and charges. As discussed in more detail in the relevant sections below, these comments generally sought clarity on the scope of fees and charges to be disclosed, including the particularity of the fees and charges to be disclosed (i.e., whether standardized or individualized disclosure would be required). In consideration of the comments received, and in light of the obligations being imposed by the Relationship Summary, we are revising Regulation Best Interest to explicitly require the disclosure of fees and costs, and are providing additional clarifying guidance. In addition, we are revising the Regulation Best Interest rule text to refer to "fees and costs" instead of "fees and charges," consistent with the approach taken in the Relationship Summary. Specifically, we are revising the Disclosure Obligation to require disclosure of "all material facts relating to the scope and terms of the relationship with the retail

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[364] *See* Proposing Release at 21600.

customer, including […] the material fees and costs that apply to the retail customer's transactions, holdings and accounts."[365]

We are also providing additional guidance addressing the scope of fees and costs to be disclosed. Namely, the Disclosure Obligation requires disclosure of *material* fees and costs relating to the retail customer's transactions, holdings and accounts. This obligation would not require individualized disclosure for each retail customer. Rather, the use of standardized numerical and other non-individualized disclosure (e.g., reasonable dollar or percentages ranges) is permissible, as discussed below.[366]

Scope of Fees and Costs to Be Disclosed

Several commenters asked for clarification about whether all fees and charges must be disclosed, or only those that are "material."[367] In response, we are revising Regulation Best Interest to make explicit that a material fact regarding the scope and terms of the relationship includes material fees and costs that apply to the retail customer's transactions, holdings and accounts. As noted above, the standard for materiality for purposes of the Disclosure Obligation is consistent with the one the Supreme Court articulated in *Basic v. Levinson;* fees and costs are

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365 Rule 15*l*-1(a)(2)(i)(A)(ii).

366 *See* Section II.C.1.a, Disclosure Obligation, Fees and Costs, *Particularity of Fees and Costs Disclosed; Individualized Disclosure*.

367 *See, e.g.*, Bank of America Letter (recommending that the Commission: (i) provide greater specificity regarding the fees to be disclosed under Regulation Best Interest, and (ii) apply a "materiality" threshold to those fees).

material and must be disclosed, if there is "a substantial likelihood that a reasonable shareholder would consider it important."[368] As noted above, in the context of this Regulation Best Interest, the standard of materiality is based on the retail customer, as defined in the rule.

We would generally expect that, to satisfy the Disclosure Obligation, broker-dealers would build upon the material fees and costs identified in the Relationship Summary, providing additional detail as appropriate. These descriptions could include, for example, an explanation of how and when the fees are deducted from the customer's account (e.g., such as on a per-transaction basis or quarterly). Although the fees and costs identified in the Relationship Summary may provide a useful starting point for the identification of the material fees and costs that may be disclosed pursuant to the Disclosure Obligation, there may be other categories of fees and costs that are material under the facts and circumstances of a broker-dealer's business model that must be disclosed pursuant to the Disclosure Obligation.

Particularity of Fees and Costs Disclosed; Individualized Disclosure

Several commenters recommended that the Commission not require that broker-dealers provide individualized fee disclosures to retail customers. Specifically, they recommended that the Commission clarify that broker-dealers could meet the Disclosure Obligation if they provide a range of fees and costs or use standardized and hypothetical amounts rather than requiring

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368 *Basic, Inc. v. Levinson*, 485 U.S. 224, 224 (1988).

disclosure of actual dollar amounts based on proposed amounts to be invested (i.e., individualized fees).[369] These commenters cited concerns about cost and practicality associated with generating individualized disclosures.[370] With regard to product-level fees in particular, several commenters expressed concern that broker-dealers could not easily calculate individualized fees and charges associated with the securities about which they provide recommendations and that doing so might lead to inadvertently providing inconsistent or inaccurate fee estimates to their retail customers.[371] In this vein, several commenters recommended that broker-dealers should be able to satisfy the Disclosure Obligation regarding product-level fees by providing retail customers with or referring them to an issuer's offering

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369 *See, e.g.,* Vanguard Letter (recommending that the Disclosure Obligation could be satisfied by relaying the types and ranges of costs associated with a recommendation, or by using standardized and hypothetical investments, rather than requiring computation of actual dollar amounts based on proposed amounts to be invested); Capital Group Letter (stating that customized mutual fund fee and expense disclosures for investors at the time of the recommendation would be impractical); SIFMA August 2018 (recommending the Commission permit disclosure of a range of customer costs per product); NASAA August 2018 Letter (suggesting that the Commission mandate its Model Fee Table along with disclosure of other fees paid for services and any other third party remuneration).

370 *See, e.g.*, TIAA Letter (stating that broker-dealers would need to expend significant resources to build new systems and new compliance programs in order to provide individualized fee disclosure); ICI Letter (recommending that the Commission confirm that the Disclosure Obligation would not require a broker-dealer to separately calculate fund fees and expenses); Capital Group Letter (stating that individualized disclosures raise significant operational burdens and compliance issues in exchange for, at best, inconsistent utility).

371 *See, e.g.*, TIAA Letter (stating that calculating individualized fee information for any retail customer would be difficult and might lead to inadvertently providing inconsistent or inaccurate fee estimate); Capital Group Letter.

materials, such as a prospectus.[372] Other commenters, on the other hand, stated that the Commission should not allow the use of percentages or ranges because such a presentation does not adequately inform investors of the fees and charges they will incur.[373]

As adopted, the Disclosure Obligation does not mandate individualized fee disclosure particular to each retail customer. Instead, broker-dealers may disclose "material facts" about material fees and costs in terms of more standardized numerical and narrative disclosures, such as standardized or hypothetical amounts, dollar or percentage ranges, and explanatory text where appropriate. The disclosure should accurately convey why a fee is being imposed and when the fee is to be charged. Further, as discussed below,[374] a broker-dealer will need to supplement this standardized disclosure with more particularized information if the broker-dealer concludes that

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372 *See* TIAA Letter (stating that broker-dealers should not be obligated to provide fund-level fee disclosure outside of a fund prospectus or to provide individualized fee disclosure to retail customers); ICI Letter (stating that when making a recommendation of a fund, a broker-dealer should be permitted to direct customers to the fund's prospectus as the source of information about fund fees and expenses); Oppenheimer Letter (stating that the fund, not the broker-dealer, is in a better position to provide these disclosures, in a manner that is accurate, consistent and complete).

373 *See, e.g.,* CFA August 2018 Letter (stating that the Commission should not allow for percentages or ranges because it would do little to inform investors); PIABA Letter (stating that broker-dealers should disclose the specific charges that their customers will incur as a result of the particular recommendation); UMiami Letter (stating that customers should be provided with clear and concise information that fully and fairly discloses the specific charges the customer will incur as a result of a particular recommendation).

374 *See* Section II.C.1.c, Disclosure Obligation, Full and Fair Disclosure, *Layered Disclosure*.

such information is necessary to fully and fairly disclose the material facts associated with the fee or charge. For example, a broker-dealer might initially disclose a range of product fees, and later supplement that information with more particularized information by delivering the product prospectus.[375]

Consistent with this approach, and also in response to comments, we are further clarifying that a broker-dealer recommending a securities transaction or an investment strategy involving securities can meet the Disclosure Obligation regarding fees and costs assessed at the product level by describing those fees and costs in initial, standardized terms and providing subsequent particularized disclosure as necessary. To the extent that such subsequent information regarding product-level fees and costs appears in a currently mandated disclosure document, such as a trade confirmation or a prospectus, delivery of that information in accordance with existing regulatory obligations will be deemed to satisfy the Disclosure Obligation, even if delivery occurs after the recommendation is made, under the circumstances outlined in Section II.C.1. Although it is not required by Regulation Best Interest, broker-dealers may refer the customer to any issuer disclosure of the security being recommended, such as a prospectus, private placement memorandum, or offering circular, where more particular information may be found.

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375 *See supra* footnote 302.

We acknowledge that the desire for greater fee transparency was a consistent theme of our investor engagement and we believe that the Disclosure Obligation, in conjunction with the Relationship Summary, significantly advances that goal. Individualized fee disclosure may be helpful to some retail customers, but it can also be costly, prone to errors, and cause delays in trade execution. In addition, in some cases the precise amount of the fee may be based on the dollar value of the transaction, and would not be known prior to or at the time of the recommendation, meaning that it could only be expressed in more general terms, such as a percentage value or range, as an initial matter. We believe that adopting the Disclosure Obligation that allows for the use of standardized disclosure furthers our goal of informing investors about fees and costs by the time of a recommendation in a workable manner. Nothing in Regulation Best Interest prevents a broker-dealer from providing such individualized disclosure to its customers should it wish to do so, and we encourage firms to assist retail customers in understanding the specific fees and costs that apply, and to provide more individualized disclosure where appropriate, or in response to a retail customer's request. As a best practice, firms may also consider reviewing with their retail customers the effect of fees and costs on the retail customer's account(s) on a periodic basis.[376] The costs, errors, delays, and other practical obstacles to individualized fee disclosure are likely to fall over time. We will

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[376] Although we encourage firms to have this conversation with their retail customers, we are not suggesting that engaging in such a best practice would, by itself, create any implied or explicit obligation to monitor such fees and costs.

continue to consider whether to require more personalized fee disclosure, particularly as technology evolves to address operational and technological costs.

With regard to the disclosure of product-level fees in particular, while we support the goal of bringing greater transparency to all fees incurred, we are seeking to supplement, not supplant, the existing regulatory regime currently applicable to product-level fees with the adoption of Regulation Best Interest. We acknowledge that if a broker-dealer highlights such fees with particularity, it may raise a customer's awareness of them, and we encourage as a best practice that broker-dealers do so.[377] We acknowledge also that the nature and extent of product-level disclosures may vary. However, we do not believe that requiring broker-dealers to deliver product disclosures earlier than is currently required, to generate fee disclosure not currently required of issuers, or to recalculate or highlight specific product-level fees already disclosed in an issuer's offering materials will meaningfully improve fee disclosure and it may, in fact, be unduly burdensome and raise the possibility of errors if broker-dealers were to be obligated to project or calculate product fees based on product issuer information. Accordingly, we believe that allowing broker-dealers to meet the Disclosure Obligation with regard to product-level fees by describing those fees in standardized terms with further detailed, particularized information related to the recommendation provided either prior to or at the time of the recommendation or

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[377] With regard to product-level fees, in particular, broker-dealers may wish to highlight certain categories of fees such as distribution fees, platform fees, shareholder servicing fees and sub-transfer agency fees, in order to enhance retail customers' understanding of these fees to the extent applicable to the customer's transactions, holdings, and accounts.

afterwards under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*, strikes an appropriate balance between costs to firms and benefits to retail customers.[378]

We believe this approach is bolstered by the existence of complementary obligations protective of retail customers that are imposed by Regulation Best Interest. For example, to the extent fees and costs incurred related to these products create conflicts of interest associated with a recommendation, we believe they are appropriately highlighted and addressed in the context of the conflicts and incentives they create to make a recommendation, and must be addressed as part of the obligation to disclose material facts about conflicts of interest associated with a recommendation, as discussed below.[379]

Moreover, under the Care Obligation, a broker-dealer recommending a securities transaction or investment strategy involving securities to a retail customer must consider costs associated with that recommendation when determining whether it is in the best interest of that retail customer. As a result, disclosure of product-level fees and costs to satisfy the Disclosure Obligation will be supplemented by other aspects of Regulation Best Interest.

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[378] *See* Section II.C.1, Disclosure Obligation, *Oral Disclosure or Disclosure After a Recommendation*.

[379] *See* Section II.C.1.b, Disclosure Obligation, Material Facts Regarding Conflicts of Interest.

While the Disclosure Obligation provides broker-dealers with flexibility in describing the material fees and costs that apply, the disclosure should accurately convey why the fee or charge is being imposed and when the fee or charge is to be assessed. For example, describing a commission or markup as a fee for "handling services" could inappropriately disguise the fee's true nature. Furthermore, while using a percentage or dollar range to describe a fee can be appropriate, that range should be designed to reasonably reflect the actual fee to be charged. For example, a statement that a charge may be "between 5 and 100 basis points" would not be accurate if the fee is in almost all instances between 85 and 100 basis points. However, in this case, a broker-dealer could accurately describe the fee, for example, as "generally being between 85 and 100 basis points, sometimes lower, but never above." In some cases, actual dollar values based on a hypothetical transaction may facilitate customer understanding.

A material fact about fees and costs could also include informing a retail customer of a fee's triggering event, such as a fee imposed because an account minimum falls below a threshold and whether fees are negotiable or waivable.

Type and Scope of Services Provided

In the Proposing Release, we provided guidance that 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 terms and scope of the relationship," that would require disclosure

pursuant to the Disclosure Obligation.[380] Specifically, we stated that broker-dealers should 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.[381]

In particular, we noted that under proposed Form CRS 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 products.[382] We recognized that a broker-dealer that offers different account types, or offers varying additional services to the retail customer may not be able, within the content and space constraints of the Relationship Summary, to provide "all material facts relating to the scope and terms of the relationship" with the retail customer.[383] Thus, we stated that pursuant to the proposed Disclosure Obligation, we would have generally expected broker-dealers to disclose these types of material facts concerning the actual services offered as part of the relationship with the retail customer separately from the Relationship Summary.

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380 *See* Proposing Release at 21602.

381 *Id.*

382 *See* Relationship Summary Proposing Release at 31426.

383 *See* Section II.C.1.a, Disclosure Obligation, *Standard of Conduct*.

Commenters generally agreed that it was important for broker-dealers to disclose to their customers material facts about the type and scope of services they provide to their customers.[384] However, commenters sought clarity regarding the application of this proposed guidance, and raised questions about whether firms would be specifically required to disclose certain services (e.g., monitoring account performance and providing financial education) pursuant to Regulation Best Interest,[385] as discussed below, and the level of disclosure required under Regulation Best Interest.[386]

Consistent with our approach in the Proposing Release, we continue to believe that the type and scope of services a broker-dealer provides to its retail customers are "material facts relating to the scope and terms of the relationship." Accordingly, we are revising the rule text to explicitly require the disclosure of 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," as part of the "material facts relating to the

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384 *See, e.g.,* Pacific Life August 2018 Letter; Cetera August 2018 Letter.

385 *See, e.g.,* Betterment Letter (recommending that the Commission ensure that dual-registrants communicate which of their services are advisory in nature); Northwestern Mutual Letter.

386 *See, e.g.*, Cetera August 2018 Letter (stating that a best interest standard should include a requirement to deliver a summary description of the relationship between the firm and customer, including the scope of services); Committee of Annuity Insurers Letter (recommending the Commission clarify that a broker-dealer could satisfy the Disclosure Obligation by disclosing the products and services available to its retail customers and does not need to disclose information particularized to a recommendation).

scope and terms of the relationship" that must be disclosed pursuant to the Disclosure Obligation.[387]

We are interpreting the Disclosure Obligation to only require disclosure of material facts relating to the type of services provided (e.g., the fact that the broker-dealer monitors securities transactions and investment strategies) and the scope of services (e.g., information about the frequency and duration of the services). In response to comments, we are also specifically addressing the disclosure of information regarding whether or not the broker-dealer provides account monitoring services and whether the broker-dealer has account minimums or similar requirements.

In addition, in response to comments, we are clarifying that pursuant to the Disclosure Obligation, broker-dealers need to disclose only material information relating to the "type and scope of services provided." As discussed in the context of the disclosure of fees and costs above, the standard for materiality of the type and scope of services to be disclosed is consistent with the standard articulated in *Basic v. Levinson*: information related to the type and scope of services provided is material, and must be disclosed, if there is "a substantial likelihood that a reasonable shareholder would consider it important."[388] As noted above, in the context of Regulation Best Interest, this standard would apply in the context of retail customers, as defined.

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387 Rule 15*l*-1(a)(2)(i)(A)(iii).

388 *Basic, Inc. v. Levinson*, 485 U.S. 224, 224 (1988).

We believe the information included in the Relationship Summary may provide a useful starting point for the identification of the type and scope of services that must be disclosed pursuant to the Disclosure Obligation. For example, in the Relationship Summary a broker-dealer must describe its principal brokerage services offered, including buying and selling securities, and whether or not it offers recommendations to retail investors.[389] Additionally, in the Relationship Summary, if applicable, the broker-dealer must address whether or not the firm offers monitoring of investments.

We believe that broker-dealers will generally need to build upon the disclosures made in the Relationship Summary as appropriate, and to 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 (e.g., the frequency and duration of the services), as necessary, in order to meet the Disclosure Obligation's requirement to disclose "all material facts" regarding the type and scope of services provided. Broker-dealers may be able to satisfy this aspect of the Disclosure Obligation by relying on their existing disclosures about the type and scope of their services, typically reflected in their account opening agreement or other account opening related documentation, so long as the disclosure as a whole addresses the material facts relating to the type and scope of services offered to the retail customer.

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[389] *See* Form CRS, Item 2.B. (Description of Services).

Disclosure of Material Limitations on Securities and Investment Strategies

In the Proposing Release, we included any limitations on the products and services offered as an example of a material fact relating to the terms and scope of the relationship that would need to be disclosed pursuant to the Disclosure Obligation. We agree with commenters who advocated for helping investors to understand whether a broker-dealer limits its product offerings, and to what extent, before entering into a relationship with a broker-dealer.[390] We continue to believe that broker-dealers that place material limitations on the securities or investment strategies involving securities that may be recommended to retail customers—such as recommending only proprietary products or a specific asset class—need to describe the material facts relating to those limitations.[391]

Therefore, in response to comments, we are revising Regulation Best Interest to explicitly require that, as part of the disclosure of the type and scope of services provided to the retail

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390 *See* CFA Institute Letter (stating that if a broker-dealer only offers proprietary products, it should clearly call attention to the higher product cost and the potential cost to the investor of such a limited offering); SIFMA August 2018 Letter (stating that a firm should be able to limit its offerings to a particular subset of its customers to proprietary product or revenue sharing products as long as: (1) the broker-dealer discloses that it is limiting its recommendation to a specific set of securities and (2) the specific set of securities contains appropriate securities to meet the customer's needs); SPARK Letter (recommending that the Commission permit broker-dealers that only offers proprietary products or a limited menu of investments to satisfy the conflict mitigation requirements by: (1) disclosing any material limitations on the investment products being offered and (2) reasonably concluding that the limitations will not violate the Care Obligation).

391 *See* Form CRS, Item 2.B.(iii).

customer, a broker-dealer must include "any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer."[392] For purposes of this requirement, a "material limitation" placed on the securities or investment strategies involving securities could include, for example, recommending only proprietary products (e.g., any product that is managed, issued, or sponsored by the broker-dealer or any of its affiliates), a specific asset class, or products with third-party arrangements (e.g., revenue sharing, mutual fund service fees).[393] Similarly, the fact that the broker-dealer recommends only products from a select group of issuers, or makes IPOs available only to certain clients, could also be considered a material limitation. To cite another example, if an associated person of a dually registered broker-dealer only offers brokerage services, and is not able to offer advisory services, the fact that the associated person's services are materially narrower than those offered by the broker-dealer would constitute a material limitation.

We recognize that, as a practical matter, all broker-dealers limit their offerings of securities and investment strategies to a greater or lesser degree. We do not believe that disclosing the fact that a broker-dealer does not offer the *entire* possible range of securities and

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392 Rule 15*l*-1(a)(2)(A). *See also* Section II.C.1 for a discussion of the materiality standard under *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

393 This is consistent with the approach we are taking in the Relationship Summary Adopting Release.

investment strategies would convey useful information to a retail customer, and therefore we would not consider this fact, standing alone, to constitute a material limitation.[394]

In addition, we believe that there are a number of reasonable practices by which appropriate limitations are determined, including processes for the selection of a "menu" of products that will be available for recommendations to retail customers. We further recognize that these limitations can be beneficial, such as by helping ensure that a broker-dealer and its associated persons understand the securities they are recommending, as required by paragraph (a)(2)(ii)(A) of the Care Obligation. We have also explicitly stated that Regulation Best Interest would not prohibit a broker-dealer from recommending, for example, a limited range of products, or only proprietary products, provided the broker-dealer satisfies the component obligations of Regulation Best Interest. Nonetheless, because these firm-wide threshold decisions have such a significant effect on the subsequent recommendations ultimately made to a retail customer, we are requiring disclosure of the material limitations on the securities or investment strategies involving securities that may be recommended—by the broker-dealer and its associated persons—as well as any associated conflicts of interest.

Explicitly requiring disclosure of these limitations is also consistent with our approach in the Care and Conflict of Interest Obligations. As discussed below, despite the potential beneficial aspects of some limitations, we are concerned that such limitations and any associated

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394 *See Basic, Inc. v. Levinson*, 485 U.S. 224, 224 (1988).

conflicts of interest can negatively affect the securities or investment strategies recommended to a retail customer.[395] In recognition of this concern, we have revised the Conflict of Interest Obligation to specifically require the establishment of policies and procedures to identify, disclose, and address that risk.[396] Furthermore, we reiterate that even if a broker-dealer discloses and addresses any material limitations on the securities or investment strategies involving securities recommended to a retail customer, and any associated conflicts of interest, as required by the Disclosure and Conflict of Interest Obligations, it would nevertheless need to satisfy the Care Obligation in recommending such products.[397]

Account Monitoring Services

In the Proposing Release, we identified as a material fact relating to the scope and terms of the relationship with the retail customer the type and scope of services provided by the broker-dealer, including, for example, monitoring the performance of the retail customer's account.[398] Additionally, the Proposing Release stated that to the extent that the broker-dealer agrees with a retail customer by contract to provide periodic or ongoing monitoring of the retail customer's investments for purposes of recommending changes in investments, Regulation Best Interest

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395 *See* Section II.C.3, Conflicts of Interest. *See* Proposing Release at 21608 (asking commenters to comment on whether, and, if so why, the Commission should require specific disclosure on product limitations).

396 *See* Section II.C.4.

397 *See* Section II.C.2.

398 Proposing Release at 21600.

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.[399]

Commenters suggested that broker-dealers should be required to clearly define the nature of account monitoring services offered, with some commenters pointing to retail customer confusion on this topic.[400] One commenter stated that disclosure will not help a retail customer of a dual-registrant who has both brokerage and advisory accounts, who is unlikely to remember which accounts his or her financial advisor is responsible for monitoring, and for which accounts the customer bears that responsibility. Accordingly, the commenter recommends that we require broker-dealers to monitor all retail customers' accounts.[401]

As discussed in the Solely Incidental Interpretation, we disagree with commenters who suggested that any monitoring of customer accounts would require a broker-dealer to register as an investment adviser and we believe that it is important for retail customers to understand: (1) the types of account monitoring services (if any) a particular broker-dealer provides, and (2)

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399 *Id.* at 21594.

400 *See, e.g.*, NAIFA Letter (asserting broker-dealers should be free to agree to, and define the nature of, any ongoing relationship via contract, such as including monitoring services); *see also* RAND 2018 (stating that participants demonstrated a lack of clarity on how a financial professional would monitor an account); OIAD/RAND (stating that some participants perceived that continuous monitoring of a client's account is consistent with acting in the client's best interest).

401 AFL-CIO April 2019 Letter.

whether or not the broker-dealer will be providing monitoring services for the particular retail customer's account. Accordingly, we believe that whether or not the broker-dealer will monitor the retail customer's account and the scope and frequency of any account monitoring services that a broker-dealer agrees to provide are material facts relating to the type and scope of services provided to the retail customer and must be disclosed pursuant to the Disclosure Obligation. This disclosure could indicate, for example, that the broker-dealer will monitor the account or investments at a stated frequency in light of the retail customer's investment objectives for the purpose of recommending an asset reallocation where appropriate, or that the broker-dealer will monitor the account periodically to determine whether a brokerage account continues to be in the retail customer's best interest. Or, broker-dealers that offer no account monitoring services could disclose that they will not monitor the account or consider whether any recommendations may be appropriate unless the retail customer specifically requests that they do so.[402]

The Relationship Summary requires broker-dealers to explain whether or not they monitor retail investors' investments, including the frequency and any material limitations.[403]

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402 As discussed in footnote 167, we recognize that a broker-dealer may voluntarily, and without any agreement with the customer, review the holdings in a retail customer's account for the purposes of determining whether to provide a recommendation to the customer. We do not consider this voluntary review to be "account monitoring," nor would it in and of itself on its own to create an implied agreement with the retail customer to monitor the customer's account. Any explicit recommendation made to the retail customer as a result of any such voluntary review would be subject to Regulation Best Interest.

403 *See* Form CRS, Item 2.B.(i).

However, as noted above, because the Relationship Summary provides high-level disclosure, in most cases it generally would not be sufficiently specific to inform investors about the scope and frequency of any account monitoring services applicable to the particular retail customer's account. The Disclosure Obligation is designed to provide investors with an expanded description of the material information relating to such services. Furthermore, as discussed in Section 2.B.2.b., Regulation Best Interest applies to recommendations resulting from agreed-upon account monitoring services (including implicit hold recommendations). Requiring disclosure of whether or not the broker-dealer will monitor the retail customer's account, and the scope and frequency of such monitoring, will help retail customers understand the terms applicable to the particular retail customer's account. While retail customers with multiple accounts will have to keep track of the accounts for which their broker-dealer has agreed to monitor, we believe that requiring disclosure of this service will provide those retail customers with sufficient clarity about the monitoring services they may expect. Requiring all broker-dealers to monitor all retail customer accounts, as one commenter suggested, would diminish the options available to retail customers, who may wish to have their accounts monitored to a greater or lesser degree (including not at all).

Account Balance Requirements

The Proposing Release did not address whether a broker-dealer offering brokerage accounts subject to account balance requirements is a "material fact relating to the scope and

terms of the relationship." However, several commenters to the Form CRS proposal suggested that the Commission require firms to disclose any account balance requirements in the Relationship Summary.[404] We believe that account balance requirements are a material fact relating to the terms and scope of the relationship. Consequently, we are interpreting the Disclosure Obligation to include disclosure of whether a broker-dealer has any requirements for retail customers to open or maintain an account or establish a relationship, such as a minimum account size. We believe that if a broker-dealer will only open a brokerage account for a retail customer with a specific account minimum, such a basic operational aspect of the account is a material fact relating to the type and scope of services provided. If dollar thresholds or other requirements apply to a retail customer's ability to *maintain* an existing account, or to avoid additional fees when the threshold is crossed (for example, a "low account balance" fee), such requirements also would likely be of importance to a retail customer.[405] We further believe retail customers can use facts about different account size requirements for both current and future planning and decision-making purposes. Accordingly, the Commission believes this information constitutes a "material fact" that must be disclosed pursuant to the Disclosure Obligation.

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404 *See, e.g.*, NASAA Letter (stating that "Form CRS should specify minimum account size and include information on miscellaneous fees different categories of investors can expect to pay."); Cetera August 2018 Letter (stating that Form CRS should include "[w]hether or not the firm has established standards for the minimum or maximum dollar amount of various account types;" and submitting mock-up form that include disclosures of account minimums); Primerica Letter. *See* Relationship Summary Adopting Release.

405 *See* Relationship Summary Adopting Release.

Other Material Facts Related to the Scope and Terms of the Relationship

In the Proposing Release, although we identified the broker-dealer's capacity, fees and charges, and type and scope of services provided as examples of what would generally be considered "material facts relating to the scope and terms of the relationship with the retail customer," we noted that the Disclosure Obligation would also require broker-dealers and their associated persons to determine, based on the facts and circumstances, whether there are other material facts relating to the scope and terms of the relationship that would need to be disclosed.[406] We also asked for comment on whether examples of other information relating to scope and terms of the relationship should be highlighted by the Commission as likely to be considered a material fact relating to the scope and terms of the relationship that would need to be disclosed.[407]

A number of commenters provided suggestions of additional examples of such material facts that the Commission should highlight or explicitly require to be disclosed as a "material fact relating to the scope and terms of the relationship." Specifically, commenters raised whether a broker-dealer's basis for,[408] and risks associated with, [409] a recommendation, or the standard of

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406 *See* Proposing Release at 21600-21601.

407 *See* Proposing Release at 21607.

408 *See infra* footnote 411.

409 *See infra* footnote 412.

conduct applicable to a broker-dealer making a recommendation,[410] should be material facts relating to the scope and terms of the relationship.

Basis for and Risks Associated with the Recommendation

The Proposing Release did not address whether a broker-dealer's basis for a recommendation is a "material fact relating to the scope and terms of the relationship." However, several commenters requested that the Commission treat a broker-dealer's basis for a recommendation as a "material fact relating to the scope and terms of the relationship" that would likely need to be disclosed prior to, or at the time of the recommendation, pursuant to the Disclosure Obligation.[411] Similarly, several commenters suggested that the Commission should treat risks associated with a broker-dealer's recommendation as "material facts relating to the scope and terms of the relationship" that would likely need to be disclosed prior to, or at the time of the recommendation.[412] Other commenters opposed requiring particularized disclosure of the basis of individual recommendations, stating that it is sufficient to disclose that different

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410 *See infra* footnote 417.

411 *See, e.g.,* PIABA Letter (recommending that broker-dealers be required to provide a clear and understandable explanation as to the other lower cost investments which are available, and why the higher cost investment is being recommended); Morningstar Letter (recommending that the Commission require a firm to disclose its analysis of the reasons it is recommending a rollover from an ERISA-covered retirement plan to an IRA and why it is in the participant's best interest).

412 *See, e.g.*, PIABA Letter (recommending that the Commission extend the Disclosure Obligation to include the risks, benefits, and ramifications of a recommendation).

products are available with different features rather than require firms specify why the broker-dealer recommended one product over another.[413]

Our view is that the general basis for a broker-dealer's or an associated person's recommendations (i.e., what might commonly be described as the firm's or associated person's investment approach, philosophy, or strategy) is a material fact relating to the scope and terms of the relationship with the broker-dealer that must be disclosed pursuant to the Disclosure Obligation. The process by which a broker-dealer and an associated person develop their recommendations to retail customers is of fundamental importance to the retail customer's understanding of what services are being provided, and whether those services are appropriate to the retail customer's needs and goals. We believe that such a description can be made in standardized or summary form; however the disclosure should also address circumstances of

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413 *See, e.g.,* LPL August 2018 Letter (stating that a broker-dealer could satisfy the Care Obligation if it recommends a more expensive investment product so long as it discloses that the recommended product is not the least expensive among the alternatives and is otherwise in the investor's best interest); Committee of Annuity Insurers Letter (recommending that the Commission clarify that a broker-dealer could satisfy the Disclosure Obligation through the use of a disclosure describing the products and services available to its retail customers and related conflicts of interest, and that a broker-dealer or associated person need not provide a disclosure particularized to a recommendation). *See also* CCMC Letters (requesting that the SEC confirm that it is sufficient to disclose that different products are available with different features rather than require firms to also document why the firm recommended one product over another); IPA Letter (requesting additional guidance regarding specificity of disclosure needed to demonstrate why a broker-dealer recommended one of multiple different products (with different terms, cost structures and conditions) that each meet the customer's investment objective).

when the standardized disclosure does not apply and how the broker-dealer will notify the customer when that is the case. For example, if an associated person has a distinct investment approach, as may be the case with persons associated with an independent contractor broker-dealer, the broker-dealer's standardized disclosure should indicate how its associated persons will notify retail customers of their own investment approach.

While the general basis for the recommendation is a material fact for purposes of the Disclosure Obligation, we decline to require disclosure of the basis for each recommendation, an approach that could involve significant costs and in many cases may simply repeat the more standardized disclosure that we are already requiring. With regard to how conflicts of interest may affect the basis for a particular recommendation, we note that the Disclosure Obligation requires disclosure of the material facts relating to the conflicts of interest associated with the recommendation, which will help retail customers evaluate the incentives a broker-dealer or associated person may have in making a recommendation; and the Conflict of Interest Obligation requires a broker-dealer to have policies and procedures to mitigate, and in certain instances, eliminate, specified conflicts of interest. Accordingly, to the extent the basis for any recommendation is subject to any conflicts of interest, the Commission believes that the Care Obligation's substantive requirement to have a reasonable basis for the recommendation, combined with the Disclosure, Conflict of Interest and Compliance Obligations, provides sufficient protections to broker-dealers' retail customers.

Similarly, we are interpreting disclosure of the risks associated with a broker-dealer's or associated person's recommendations in standardized terms as a material fact related to the scope and terms of the relationship that needs to be disclosed. For example, a broker-dealer could disclose: "While we will take reasonable care in developing and making recommendations to

you, securities involve risk, and you may lose money. There is no guarantee that you will meet your investment goals, or that our recommended investment strategy will perform as anticipated. Please consult any available offering documents for any security we recommend for a discussion of risks associated with the product. We can provide those documents to you, or help you to find them." This example is purely illustrative. Whether any particular disclosure by a broker-dealer is sufficient to meet the Disclosure Obligation will depend on the facts and circumstances.

The risks associated with a particular recommendation would be relevant to a retail customer. However, we believe that broker-dealers may rely on the existing disclosure regime governing securities issuers to disclose the risks associated with any issuer, security or offering,[414] and it is not our intent to require the broker-dealer to duplicate or expand on those disclosures. Consistent with our approach, discussed above, to disclosure of product-level fees and costs, we believe that describing product-level risks in standardized terms, with additional information in any available issuer disclosure documents delivered in accordance with existing

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414 *See, e.g.*, Item 503(c) of Reg. S-K (requiring disclosure of the "most significant" factors that make an offering "speculative or risky," as well as an explanation of how each risk "affects the issuer or the securities being offered." *See also* Form 10-K (requiring a description of the 503(c) risk factors that are "applicable to the registrant"). In some cases, SRO Rules applicable to recommendations of particular securities may also require disclosure of risks. *See, e.g.*, FINRA Rule 2330 (requiring a FINRA member or its associated persons recommending deferred variable annuity to have a reasonable belief that the customer has been informed of, among other things, market risk). *See also* FINRA Rule 2210(d), requiring, among other things, that statements in member communications "are clear and not misleading within the context in which they are made, and that they provide balanced treatment of risks and potential benefits."

regulatory requirements would satisfy the Disclosure Obligation. As noted above, we are not seeking to supplant the developed regulatory regime currently applicable to offering disclosure with the adoption of Regulation Best Interest.

While we believe that a standardized discussion of risks is a material fact that must be disclosed to satisfy the Disclosure Obligation, we decline to impose a disclosure requirement specific to each recommendation. As with regard to the disclosure of the individualized basis for each recommendation, we believe that such specific disclosure could involve significant costs and in many cases simply repeat the more standardized disclosure that we are requiring, which we believe will sufficiently inform retail customers, in broad terms, of the nature of the risks associated with a recommendation.

In addition, under the Care Obligation, a broker-dealer making a recommendation of a securities transaction or investment strategy involving securities to a retail customer must consider the risks when determining whether it has a reasonable basis for believing that the recommended transaction or investment strategy could be in the best interest of at least some retail customers, and is in the best interest of a particular retail customer. Moreover, under paragraph (a)(2)(B) of Regulation Best Interest, discussed below, broker-dealers need to disclose "all material facts relating to conflicts of interest that are associated with the recommendation," which will require disclosure of what we believe to be a significant risk associated with a broker-dealer's recommendations—the broker-dealer's conflicts of interest. For these reasons, we believe that standardized written disclosure of this information in general terms is sufficient.

Consistent with the Compliance Obligation, broker-dealers should consider developing policies and procedures that address the circumstances under which the basis for a particular recommendation would be disclosed to a retail customer. As a best practice, firms also should

encourage their associated persons to discuss the basis for any particular recommendation with their retail customers, including the associated risks, particularly where the recommendation is significant to the retail customer. For example, the decision to roll over a 401(k) into an IRA may be one of the most significant financial decisions a retail investor could make. Thus, a broker-dealer should discuss the basis of such recommendations with the retail customer. Similarly, we encourage broker-dealers to record the basis for their recommendations, especially for more complex, risky or expensive products and significant investment decisions, such as rollovers and choice of accounts, as a potential way a broker-dealer could demonstrate compliance with the Care Obligation.

Standard of Conduct[415]

As stated in the Proposing Release, the Commission intended the Relationship Summary to touch on issues that are also contemplated under the Disclosure Obligation, such as facilitating greater awareness of key aspects of a relationship with a firm or financial professional, such as the applicable standard of conduct.[416] Several commenters on Regulation Best Interest also requested that the Commission treat the standard of conduct applicable to a broker-dealer making the recommendation to its retail customer as a "material fact relating to the scope and terms of the relationship" that would likely need to be disclosed prior to, or at the time of the

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415 *See* Section II.C.1.a, Disclosure Obligation, *Capacity in Which the Broker-Dealer is Acting*.

416 *See* Proposing Release at 21600.

recommendation under the Disclosure Obligation.[417] Specifically, these commenters requested that the Commission require a firm to disclose whether it is providing a recommendation subject to Regulation Best Interest or advice subject to a fiduciary duty.[418]

The Commission also carefully considered numerous comments concerning the standard of conduct disclosure in proposed Form CRS, along with the results of investor testing and the Commission's Feedback Form.[419] As discussed more fully in the Relationship Summary

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417 *See, e.g.,* NASAA 2018 Letter (recommending that the Commission provide specific instructions on how associated persons of dually registered firms should disclose capacity in which they are acting and whether the information they are providing is a recommendation subject to "best interest" or advice subject to a fiduciary duty). *See also* Betterment Letter (recommending that the Commission require broker-dealers to disclose that they are "salespeople who are providing sales recommendations and not advice" in lieu of the adoption of a fiduciary duty on broker-dealers).

418 *Id.*

419 Most commenters did not object to the proposal's requirement that broker-dealers and investment advisers provide disclosure regarding their standards of conduct or that such disclosure be standardized. *See, e.g.*, CFA Institute Letter (urging the Commission to require disclosure of the standard of conduct under which broker-dealers operate); IAA August 2018 Letter. In addition, results of investor studies and surveys indicate that retail investors view this information as helpful. *See* RAND 2018 (almost one third of survey respondents selected this section as one of the two most useful; Letter from Mark Quinn, Director of Regulatory Affairs, Cetera (Nov. 19, 2018) ("Cetera November 2018 Letter") (88% of survey respondents somewhat or strongly agreed "the firm's obligations to you" is an important topic"). *See also* Schwab Letter I (Hotspex) ("obligations the firm and its representatives owe me" ranked third where survey participants were asked to identify four topics as most important for a firm to communicate"). Similarly, commenters on Feedback Forms found this information to be useful. *See* Feedback Forms Comment Summary (38% of commenters on Feedback Forms graded the "Our Obligations to You" section of the relationship summary as "very useful" and 46% graded this section as "useful").

Adopting Release, we are adopting a requirement in Form CRS for a description of a firm's applicable standard of conduct using prescribed wording.[420] This "standard of conduct" disclosure (as modified from proposed Form CRS) both eliminates technical words, such as "fiduciary," and describes the legal obligations of broker-dealers, investment advisers, or dual-registrants using similar terminology in plain English. The prescribed wording also highlights when a firm must satisfy its legal obligation—specifically, in the case of a broker-dealer, when making a recommendation.

We believe the standard of conduct owed to a retail customer under Regulation Best Interest is a material fact relating to the scope and terms of the relationship. However, given that Form CRS requires firms to disclose in prescribed language the applicable standard of conduct and, as discussed above, the Disclosure Obligation requires broker-dealers to disclose the capacity (i.e., brokerage) in which they are acting with respect to a recommendation, we believe this disclosure to be sufficient and thus requiring any additional disclosure would be duplicative.

b. Material Facts Regarding Conflicts of Interest

As noted above, in addition to requiring disclosure of the "material facts relating to the scope and terms of the relationship," the proposed Disclosure Obligation would have required a broker-dealer to disclose "all material conflicts of interest associated with the recommendation."

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[420] Form CRS, Item 3.B.(i).a (stating that "If you are a broker-dealer that provides recommendations subject to Regulation Best Interest, include: 'When we provide you with a recommendation, we have to act in your best interest and not put our interest ahead of yours'").

We proposed 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."[421] We generally modeled this proposed interpretation on the Advisers Act approach to identifying conflicts of interest for which investment advisers may face antifraud liability in the absence of full and fair disclosure.[422] We expressed our preliminary belief that a material conflict of interest that generally should be disclosed would include material conflicts associated with recommending: proprietary products, products of affiliates, or a limited range of products, or one share class versus another share class of a mutual fund; securities underwritten by the broker-dealer or an affiliate; the rollover or transfer of assets from one type of account to another (such as a recommendation to roll over or transfer assets in an ERISA account to an IRA); and allocation of investment opportunities among retail customers (e.g., IPO allocation).[423]

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421 Proposing Release at 21602.

422 *See id.* (citing *Capital Gains* (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")).

423 *See* Proposing Release at 21603.

While commenters supported the disclosure of conflicts of interest, some sought clarity on the standard for determining which conflicts should be disclosed,[424] and others requested clarity on whether conflicts involving certain actions (e.g., rollovers)[425] and products (e.g., proprietary products)[426] should be disclosed.[427]

Several commenters urged the Commission to define "conflicts of interest" without a reference to the terms "consciously or unconsciously."[428] These commenters claim that discerning a broker's conscious or unconscious state of mind is "confusing and inherently unknowable."[429] Similarly, one commenter stated that a broker-dealer would be unable to draft

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424 *See, e.g.*, SIFMA August 2018 Letter, Edward Jones Letter (requesting clarity on the definition of materiality with regards to conflicts); Ameriprise Letter (stating that the definition of "material conflicts of interest" should follow well known and understood principles); Fidelity Letter (stating that the Commission should not distinguish between conflicts of interest based on financial incentives and all other conflicts of interest); Morgan Stanley Letter; CCMC Letters; TIAA Letter; Mass Mutual Letter; Empower Letter. *See also* IRI Letter (stating that requiring a registered representative to predict what a hypothetical reasonable person might think is confusing); ICI Letter (stating that rather than focusing on what a "reasonable person would expect . . ." the standard should focus on that nature of the incentive and its effect on a broker-dealer's conduct).

425 *See, e.g.*, CFA Institute Letter.

426 *See, e.g.*, SIFMA August 2018 Letter; State Attorneys General Letter; CFA Institute Letter.

427 *See, e.g.*, Ameriprise Letter; State Attorneys General Letter; CFA August 2018 Letter.

428 *See, e.g.*, Edward Jones Letter (urging the Commission to articulate a definition of materiality that does not refer to a person's unconscious activity); Empower Letter; Ameriprise Letter.

429 *Id.*

adequate policies and procedures that address an individual's mindset, noting that it would be impossible for a broker-dealer to anticipate an individual's unconscious conflicts.[430] Instead, these commenters suggested revised language that eliminates the notion of conscious or unconscious inclination.[431] Similarly, several commenters opposed the Commission's use of the term "not disinterested."[432] These commenters believe that the term is not clear and could, among other things, suggest the elimination of all conflicts.[433] One of these commenters recommended that the Commission eliminate the term "not disinterested"[434] while another suggested that the Commission clarify whether "material" and "not disinterested" are intended to be identical or different standards for brokers and advisers.[435] Other commenters opposed the

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430 *See* Great-West Letter.

431 *See, e.g.*, Edward Jones Letter (suggesting that the Commission define "material conflict" as an activity that: (i) affects financial compensation of a person making a recommendation; and (ii) a reasonable investor would likely view as important to the total mix of information available when considering that recommendation); Ameriprise Letter (suggesting that the Commission define "material conflict of interest" as a conflict of interest that a reasonable person might conclude has the potential to influence the recommendation); Pacific Life August 2018 Letter (suggesting the Commission define "material conflict of interest" as a financial interest of the financial professional making a recommendation that a reasonable person would expect to affect the impartiality of such recommendation).

432 *See, e.g.,* IPA Letter (stating that the use of the term "not disinterested" may require unnecessary legal interpretation); Empower Letter.

433 *See, e.g.*, Empower Letter.

434 *See id*.

435 *See* IPA Letter.

proposed standard, arguing that it was not as broad as the disclosure obligation applicable to investment advisers. In particular, some commenters urged the Commission to apply the standard for disclosure applicable to investment advisers as articulated by the Supreme Court in *S.E.C. v. Capital Gains Research Bureau*.[436] Specifically, commenters requested that the Commission require disclosure of not only material conflicts but also the *material facts* related to a recommendation.[437]

We are adopting the obligation to disclose conflicts of interest, with several modifications and clarifications to the Proposing Release. Specifically, Paragraph (a)(2)(i)(B) of Regulation Best Interest requires that broker-dealers disclose "material facts relating to conflicts of interest that are associated with the recommendation."[438]

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436 375 U.S. 180 (1963). *See, e.g.,* CFA August 2018 Letter; Schnase Letter.

437 *See, e.g.,* CFA August 2018 Letter.

438 This supplements the disclosure required in the Relationship Summary regarding ways in which the broker-dealer and its affiliates make money from brokerage or investment advisory services they provide to retail investors, and about the related material conflicts of interest. The Relationship Summary requires firms to disclose, if applicable, conflicts related to compensation it could receive from proprietary products, third-party payments, revenue sharing, or principal trading. If firms do not have any of these conflicts, the firm must disclose at least one other material conflict of interest that affects retail investors. As described in the Relationship Summary Adopting Release, we declined to make a change pursuant to comments that suggested that Regulation Best Interest's and Form CRS's conflicts disclosures be coordinated, and that any conflict disclosure obligations under Regulation Best Interest should be satisfied upon delivery of the Relationship Summary. We recognize that broker-dealers may need to disclose additional conflicts at a point in time other than at the beginning of the relationship with a retail investor. Broker-dealers also may need to include additional information about conflicts of interest

However, as discussed in more detail below, in response to comments and in the light of the Relationship Summary, we are: (1) adopting for purposes of Regulation Best Interest a definition of "conflict of interest" associated with a recommendation "as an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested;" and (2) revising the Disclosure Obligation to require disclosure of "material facts" regarding such conflicts of interest. Under this approach, all conflicts of interest as interpreted under the Proposing Release will be covered by Regulation Best Interest.

We believe distinguishing between "conflicts of interest" and "material facts" regarding such conflicts that would be disclosed would make the Disclosure Obligation more consistent with the proposal's intent. In the Proposing Release, the Commission discussed limiting the disclosure of conflicts under the Disclosure Obligation "consistent with case law under the antifraud provisions, which limit disclosure obligations to "material facts."

After considering the comments, we have determined to retain the proposed approach to conflicts of interest as described in *Capital Gains*. In particular, we acknowledge commenter

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summarized in the Relationship Summary. The Relationship Summary will provide a high-level summary for retail investors so that they can engage in a conversation with their financial professional about investment advisory or brokerage services, and so that the retail investors can choose the type of service that best meets their needs, but will not necessarily include all material facts related to a particular conflict of interest. We believe many firms may not be able to capture all of the necessary disclosures about their conflicts in this short standardized disclosure.

concerns about discerning a broker's conscious or unconscious state of mind. However, the description of conflicts of interest in *Capital Gains* is well established, familiar to many in the industry, particularly dual-registrants, and guidance already exists regarding what constitutes a conflict of interest under this standard. To provide clarity that this interpretation is limited to Regulation Best Interest, however, we are revising Regulation Best Interest to explicitly provide that a "conflict of interest" "means an interest that might incline a, broker, dealer, or natural person who is an associated person of a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested,"[439] consistent with the scope of the meaning of "conflict of interest" for investment advisers under *Capital Gains.*[440]

Several commenters also made suggestions regarding the Commission's interpretation of the term "material" as used in the proposed Disclosure Obligation (i.e., the proposed requirement to disclose "all material conflicts of interest that are associated with the recommendation").[441] Many commenters agreed with the Commission's decision to use a "materiality" standard to determine those facts about conflicts of interest that must be disclosed.[442] However, several

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439 Rule 15*l*-1(b)(3).

440 For the same reasons, we have eliminated the phrase "a reasonable person would expect" that was included in the definition of "material conflict of interest" discussed in the Proposing Release at 21602.

441 *See, e.g.,* Transamerica August 2018 Letter; Fidelity Letter; SIFMA August 2018 Letter; Morgan Stanley Letter; IPA Letter; Great-West Letter.

442 *See, e.g.*, Morgan Stanley Letter; Great-West Letter.

other commenters asked the Commission to clarify the meaning of "material."[443] These latter commenters stated, among other things, that the term "material" in proposed Regulation Best Interest was not clearly defined and would be subjectively interpreted.[444] Accordingly, many of these commenters recommended that the Commission adopt a materiality standard based on the standard articulated in *Basic v. Levinson*.[445]

The Supreme Court in *Basic* articulated a standard for materiality, stating that information is material if there is "a substantial likelihood that a reasonable shareholder would consider it important."[446] This definition of "material" is well established and thus limiting disclosure to material facts in the Disclosure Obligation will eliminate confusion and reduce the compliance burden on broker-dealers in fulfilling the Disclosure Obligation. It will also help focus the information made available to retail customers.[447] Accordingly, we interpret "material facts" consistent with the *Basic* standard. Moreover, while the Regulation Best Interest

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443 *See, e.g.,* FSI August 2018 Letter (recommending the Commission publish examples of when a conflict is material); Wells Fargo Letter; Cetera August 2018 Letter; IPA Letter.

444 *See, e.g.,* Great-West Letter (stating that the Commission appears to have created a very subjective standard to determine materiality).

445 *See, e.g.,* Mass Mutual Letter; SIFMA August 2018 Letter; Bank of America Letter; CCMC Letters; TIAA Letter; Cetera August 2018 Letter; Fidelity Letter.

446 *Basic v. Levinson*.

447 As stated in the Proposing Release, we are sensitive to the potential that broker-dealers could adopt an approach that results in lengthy disclosures that undermine the Commission's goal of facilitating meaningful disclosure to assist retail customers in making informed investment decisions. Proposing Release at 21604.

definition of "conflict of interest" is modeled on the regulatory regime applicable to investment advisers, and is not by its terms explicitly limited to "material" conflicts of interest, it would be difficult to envision a "material fact" that must be disclosed pursuant to the Disclosure Obligation that is not related to a conflict of interest that is also material under the *Basic* standard.[448]

Interpretation of Disclosure of Material Facts Relating to Conflicts of Interest

In response to comments, we are providing our view regarding what we would consider "material facts relating to conflicts of interest that are associated with a recommendation" that would need to be disclosed under the Disclosure Obligation. We believe the conflicts of interest identified in the Relationship Summary may provide a useful starting point for the identification of material facts that need to be disclosed pursuant to the Disclosure Obligation.[449] In addition, we also view how a broker-dealer's investment professionals are compensated, and the conflicts associated with those arrangements, as material facts relating to conflicts of interest that are associated with a recommendation.[450] While these conflicts of interest must be summarized in the Relationship Summary to the extent they are applicable, we believe that additional details

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448 *See* Fiduciary Interpretation.

449 *See, e.g.*, Form CRS, Item 3 (Fees, Costs, Conflicts, and Standard of Conduct).

450 *See* Form CRS, Item 3.C.(i) ("*Description of How Financial Professionals Make Money*: Summarize how your financial professionals are compensated, including cash and non-cash compensation, and the conflicts of interest those payments create.").

regarding many of these conflicts need to be disclosed under the Disclosure Obligation as "material facts" relating to conflicts of interest associated with a recommendation.

Disclosure of Compensation

Broker-dealers receive compensation that typically varies depending on what securities transaction or investment strategy involving securities is being recommended. The source of the compensation may also vary, for example being paid directly by the investor, or by a product sponsor, or a combination of both. A broker-dealer may also pay its associated persons different rates of compensation depending on the type of security they sell.[451] Similarly, broker-dealers can receive different payments from different product providers (e.g., mutual funds) for a variety of reasons, such as payments for inclusion on a broker-dealer's menu of products offered (sometimes referred to as shelf space). These compensation arrangements create a variety of conflicts of interest that must be addressed under both Form CRS and the Disclosure Obligation.

We believe that compensation associated with recommendations to retail customers and related conflicts of interest—whether at the broker-dealer or the associated person level—is a conflict of interest about which material facts must be disclosed as part of the Disclosure Obligation. This disclosure should summarize how the broker-dealer and its financial professionals are compensated for their recommendations and, as importantly, the conflicts of interest that such compensation creates. This summary should include the sources and types of

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451 *See* NASD NTM 03-54.

compensation received, and may include the fact that fees and costs disclosed pursuant to Paragraph (a)(2)(i)(A) of Regulation Best Interest that a retail customer may pay directly or indirectly are a source of compensation, if that is the case. For example, if a broker-dealer receives compensation derived from the sale of securities or other investment products held by retail customers of the firm, including asset-based sales charges or service fees on mutual funds, that fact and the conflicts associated with the receipt of such compensation should be fully and fairly described.

Broker-dealers could meet the Disclosure Obligation by making certain required disclosures of information regarding conflicts of interest to their customers at the beginning of a relationship, and this form of disclosure may be standardized. However, if standardized disclosure, provided at such time, does not sufficiently identify the material facts relating to conflicts of interest associated with any particular recommendation, the disclosure would need to be supplemented so that such disclosure is tailored to the particular recommendation. For example, with regard to mutual fund transactions and holdings, a broker-dealer might disclose broadly that it is compensated by funds out of product fees or by the funds' sponsors, and that such compensation gives it an incentive to recommend certain products over other products for which the broker-dealer receives less compensation; later, when a broker-dealer recommends a particular fund, it could provide more specific detail about compensation arrangements, for example revenue sharing associated with the fund family. In the alternative, so long as the "material facts" regarding the conflicts associated with a recommendation of a mutual fund were disclosed at the outset of the relationship, no further disclosure need be made at the time of recommendation; we are not requiring that information regarding conflicts be disclosed on a recommendation-by-recommendation basis.

The Disclosure Obligation also does not require specific written disclosure of the amounts of compensation received by the broker-dealer or the financial representative. For example, we are not requiring broker-dealers to disclose the amount, if any, they compensate their financial professionals per transaction, or for year-end bonuses. We believe that disclosure of the material facts regarding conflicts of interest associated with a recommendation need not entail such individualized numerical disclosure, and that in any event such a level of detail may be difficult and costly to calculate with accuracy, and also confusing to investors in many instances. Instead, disclosure regarding conflicts must reasonably inform investors so that the investor may use the information to evaluate the recommendation, and that can be done without specific disclosure of the amount of the compensation. Although disclosure of specific compensation amounts is not required, depending on facts and circumstances, full and fair disclosure may require disclosure of the general magnitude of the compensation.[452]

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452 *See, e.g.,* Advantage Investment Management, Advisers Act Release No. 4455 (Jul. 18, 2016) (settled order) (the Commission brought an enforcement action against an adviser for failing to disclose the existence, nature and magnitude of a forgivable loan from a broker-dealer that the adviser had engaged to provide services to the adviser's clients); Taberna Capital Management LLC, Advisers Act Release No. 4186 (Sep. 2, 2015) (settled order) (the Commission brought an enforcement action against an adviser for failing to disclose the existence, nature, and extent of a conflict of interest raised by the adviser's receipt of certain fees from issuers); BISYS Fund Services, Inc., Advisers Act Release No. 2554 (Sep. 26, 2006) (settled order) (the Commission brought an enforcement action against a mutual fund administrator for failure to disclose information concerning the existence or magnitude of the conflicts of interest created by a marketing arrangement that called for BISYS to rebate a portion of its administrative fees to 27

We are also clarifying that while product fees and costs can be a significant source of compensation received by broker-dealers and associated persons, no disclosure regarding the particular amounts of these fees and costs is required under Regulation Best Interest with regard to conflicts of interest. Instead, what must be disclosed under Paragraph (a)(2)(i)(B) of Regulation Best Interest are the "material facts relating to conflicts of interest" created by compensation sourced from product fees and costs, rather than the fees and costs themselves.

Differences in Compensation and Proprietary Products

Several commenters recommended that required conflict disclosure address recommendations where a less expensive alternative is available, or condition the ability to recommend a more expensive product on the adequacy of a broker-dealer's conflict disclosures.[453] Similarly, several commenters expressed differing views on how payment of varying compensation should be handled under the "best interest" standard of Regulation Best

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mutual fund advisers so that the fund advisers would continue to recommend BISYS as an administrator).

453 *See* PIABA Letter (stating that where less expensive alternatives are available, disclosure should include an explanation of why the recommendation is nevertheless in the best interest given other factors associated with the recommendation); LPL August 2018 Letter (recommending that the Commission clarify that a broker-dealer can recommend a product involving costs and charges that are within a range of reasonableness that has been disclosed to the investor in advance provided the recommendation is otherwise in the investor's best interest); UMiami Letter; SIFMA August 2018 Letter.

Interest and how related conflicts should be disclosed.[454] For example, one commenter identified compensation differences within product lines as an example of a conflict that should be disclosed.[455] Several commenters also recommended that the Commission require disclosure of conflicts of interest related to use of proprietary products, and whether the broker-dealer offers alternatives to proprietary products.[456] Similarly, several commenters requested that the Commission clarify that broker-dealers can limit their offerings to proprietary products or products that make revenue sharing payments if, among other things, appropriate disclosure is made.[457]

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454 *See, e.g.,* CFA August 2018 Letter (recommending that the Commission include compensation differences within product lines as an example of a conflict that should be disclosed); Ameriprise (stating that differential compensation for diverse products aligns with Regulation Best Interest provided the firm mitigates the potential related conflicts); Pacific Life August 2018 Letter (stating that the definition of "material conflicts of interest" must encompass, among other things, the types of compensation received by the person making the recommendation).

455 *See* CFA August 2018 Letter.

456 *See, e.g.*, Money Management Institute Letter (recommending the SEC allow firms to meet the Conflict of Interest Obligation with respect to their preference for proprietary products through disclosure); CFA Institute Letter; IRI Letter; SIFMA August 2018 Letter.

457 *See, e.g.,* SIFMA August 2018 Letter (stating that a firm should be allowed to limit its offerings to proprietary products or revenue sharing products, as long as: (a) the broker-dealer discloses to its customer that it is limiting the recommendation to a specific set of securities, and (b) the specific set of securities contains appropriate securities to meet the customer's needs); CFA Institute Letter (stating that when a firm only offers proprietary products it should disclose not only the higher product cost, but the potential cost to the investor of such a limited offering).

As discussed above, we agree with commenters who stated that it may be compatible with the Care Obligation to recommend a more expensive product that is otherwise in a retail customer's best interest when there are less expensive alternatives available, to receive compensation that varies among products, and to recommend proprietary products.[458] However, we also believe that the conflicts of interest associated with such practices constitute "material facts" relating to conflicts of interest that must be disclosed under the Disclosure Obligation.

The receipt of higher compensation for recommending some products rather than others, whether received by the broker-dealer, the associated person, or both, is a fundamental and powerful incentive to favor one product over another.[459] While we are requiring firms to establish policies and procedures reasonably designed to mitigate the conflicts of interest that create an incentive for financial professionals to place the interest of the professional or broker-dealer ahead of the interest of the retail customer, we believe also that full and fair disclosure of the material facts concerning conflicts raised by variable compensation schemes is of particularly critical importance for an investor seeking to evaluate a recommendation under such

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458 *See generally* Section II.A.1, Commission's Approach.

459 *See* Proposing Release at 21578 (referencing the Commission's 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); FINRA Report on Conflicts of Interest (Oct. 2013), *available at* https://www.finra.org/sites/default/files/Industry/p359971.pdf ("FINRA Conflicts Report") at p. 4.

circumstances, a concern further underscored by our approach under the Conflict of Interest Obligation of requiring policies and procedures to mitigate or eliminate certain conflicts.[460]

The benefits that accrue to a broker-dealer and its financial professionals from recommending proprietary products also raise conflicts of interest that must be disclosed. Material facts relating to the conflicts of interest associated with recommending proprietary products could include, as relevant, that the broker-dealer owns the product, and that in addition to any commission associated with purchasing the product, the broker-dealer or an affiliate may receive additional fees and compensation[461] related to that product.[462]

c. Full and Fair Disclosure

As proposed, the Disclosure Obligation would have required broker-dealers to "reasonably disclose" material facts relating to the scope and terms of the relationship with the retail customer, including all material conflicts of interest associated with the recommendation. The Commission used this formulation in order to give flexibility to broker-dealers in determining the most appropriate way to meet the proposed Disclosure Obligation depending on

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460 *See generally* Section II.C.3.

461 For example, a broker-dealer's sale of proprietary products potentially generates a compensation stream for the broker-dealer, in addition to commissions, which may need to be disclosed under paragraph (a)(2)(i)(A).

462 As discussed further in Section II.C.3, in addition to disclosure of such conflicts, broker-dealers are also required under the Conflict of Interest Obligation to establish, maintain, and enforce written policies and procedures reasonably designed to mitigate or address the conflicts presented.

their individual business practices. The Commission also provided preliminary guidance on what it believed 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.

In this regard, the Commission requested comment on whether broker-dealers should be required to "reasonably disclose" and whether additional guidance as to how broker-dealers could meet this standard should be provided. The Commission also requested comment on whether disclosure should explicitly be required to be "full and fair." In response, some commenters raised questions about using the term "reasonably disclose"[463] and whether broker-dealers should be subject to less rigorous disclosure obligations for recommendations made to retail customers than investment advisers.[464] These commenters recommended that the Commission explicitly require broker-dealers to provide full and fair disclosure of material facts.[465] One commenter reasoned that the Commission should not make Regulation Best

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463 *See*, *e.g.,* CFA August 2018 Letter (stating that a "reasonable" disclosure standard gives firms too much discretion to determine how the disclosures will be presented); Galvin (arguing that the proposed standard would give broker-dealers more opportunities to argue that they acted "reasonably" under the rules).

464 *See, e.g.*, CFA August 2018 Letter (stating that "[t]he Commission offers no explanation for why broker-dealers should be subject to less rigorous disclosure obligations than investment advisers").

465 *See, e.g.*, Pace Investor Rights Clinic August 2018 Letter (urging the Commission to require broker-dealers to provide full and fair disclosure of any conflicts that are not eliminated or mitigated); Better Markets August 2018 Letter (urging the Commission to

Interest any more stringent than in the Proposing Release, stating that "full and fair" is both inapplicable and unnecessary given the proposed standard under the Disclosure Obligation.[466]

After careful consideration of the comments received, the Commission is adopting the Disclosure Obligation with revisions to require "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 associated with the recommendation for the reasons described below.

While we do not believe that adopting a "full and fair disclosure" standard is significantly different from the proposed requirement to "reasonably disclose," we believe that the Regulation Best Interest serves the Commission's goal of facilitating disclosure to assist retail customers in making informed investment decisions.[467] In addition, Regulation Best Interest will more

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further enhance the Disclosure Obligations by requiring broker-dealers to make full and fair disclosure of all information required to be disclosed); State Attorneys General Letter; NASAA August 2018 Letter.

466 *See* SIFMA August 2018 Letter.

467 This approach is consistent with the rationale articulated in the Fiduciary Interpretation. *See* Fiduciary Interpretation at Section II.C (stating, "In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent. For example, it would be inadequate to disclose that the adviser has 'other clients' without describing how the adviser will manage conflicts between clients if and when they arise, or to disclose that the adviser has 'conflicts' without further description. Similarly, disclosure that an adviser 'may' have a particular conflict, without more, is not adequate when the conflict actually exists." [However,] "[t]he word 'may' could be appropriately used to disclose to a client a potential conflict that does not currently exist

closely align the Disclosure Obligation with existing requirements for investment advisers[468] and is consistent with disclosure standards in other contexts under the federal securities laws.[469]

The full and fair disclosure standard that the Commission is adopting for broker-dealers under the Disclosure Obligation is generally similar to the disclosure standard applicable to

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but might reasonably present itself in the future."). *See also In the Matter of The Robare Group, Ltd., et al.*, Advisers Act Release No. 4566 (Nov. 7, 2016) (Commission Opinion) (finding, among other things, that adviser's disclosure that it *may* receive a certain type of compensation was inadequate because it did not reveal that the adviser actually had an arrangement pursuant to which it received fees that presented a potential conflict of interest); *aff'd in part and rev'd in part on other grounds Robare Group, Ltd., et al. v. SEC*, 922 F.3d 468 (D.C. Cir. 2019); *SEC v. Blavin,* 760 F.2d 706, 711 (6th Cir. 1985) (disclosure that investment adviser "may" trade in recommended securities for its own account was false and misleading where the adviser actually invested in 10%-25% of the publicly available stock of the companies it recommended); ICI Letter (commenting on the Fiduciary Interpretation proposing release).

468 *See* Fiduciary Interpretation at Section II.A (stating that "[t]he [investment adviser's] fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement provided that there is *full and fair disclosure* and informed consent" (emphasis added)).

469 For instance, the Municipal Securities Rulemaking Board requires that municipal advisors provide full and fair disclosure of material conflicts of interest and material legal or disciplinary events. *See* MSRB Rule G-42. In addition, the registration and disclosure requirements of the Securities Act of 1933 ("Securities Act") are based on the concept that investors in a public offering should be provided with full and fair disclosure of material information needed for an informed investment decision. *See* Securities Act Concepts and Their Effects on Capital Formation, Securities Act Release No. 7314 (Jul. 25, 1996); 61 FR 40044 (Jul. 31, 1996) at text accompanying footnote 13; *see also* SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953). Finally, Regulation FD under the Securities Act was "designed [in part] to promote the full and fair disclosure of information by issuers." *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7881 (Aug. 15, 2000), 65 FR 51715 (Aug. 24, 2000).

investment advisers under the Advisers Act.[470] Similar to the Proposing Release's interpretation of the phrase "reasonably disclose," broker-dealers' obligation to provide full and fair disclosure should give sufficient information to enable a retail investor to make an informed decision with regard to the recommendation.[471]

We disagree with commenters who believe the "full and fair" standard is too stringent. While the general standard for broker-dealers under the Disclosure Obligation will be generally similar to the disclosure requirements applicable to investment advisers, the scope of the required disclosure is not as broad. For example, the Disclosure Obligation only requires disclosure of material facts relating to the *scope and terms* of the relationship with the broker-dealer, and material facts relating to conflicts of interest associated with a broker-dealer's recommendations, and not of all material facts relating to the relationship. In addition, the Disclosure Obligation only applies to retail customers. In contrast, the disclosure requirements imposed by the fiduciary duty under the Advisers Act generally and Form ADV in particular are broader (e.g., Form ADV requires disclosure of the adviser's principal owner(s) and certain financial industry activities and affiliations, which are not explicitly required under the Disclosure Obligation; Form ADV and the fiduciary duty also go to disclosure of the entire relationship while the

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470 *See supra* footnote 468. *See also* Fiduciary Interpretation, stating that the disclosure "should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent."

471 *See* Proposing Release at 21604, footnote 208.

Disclosure Obligation is tailored to the recommendation and also given at relevant points in time). We designed our approach to avoid having retail customers receive overwhelming amounts of information.[472]

Some commenters suggested that disclosure and informed consent should be required in order to comply with the obligations under Regulation Best Interest, similar to the approach taken under the fiduciary duty under the Advisers Act.[473] We have carefully considered these comments. As noted above, under the Disclosure Obligation, broker-dealers are required to provide full and fair disclosure such that a retail customer can make an informed decision with regard to the recommendation (i.e., whether to accept (or reject) that recommendation). In making such an informed decision after being provided with full and fair disclosure, we believe that the retail customer has provided "informed consent" in a manner that is analogous to the informed consent required to be provided by a client in the context of an investment adviser-

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472 Commenters pointed out that requiring too much information regarding conflicts of interest would go beyond the standard of materiality set forth under *Basic*. *See, e.g.*, SIFMA August 2018 Letter; Cetera August 2018 Letter (citing *Basic* at 231, noting that "an avalanche of trivial information" would not be "conducive to informed decision making."). *See also* Letter from David Schwartz, President and CEA, Florida International Bankers Association ("FIBA") (Feb. 8, 2019) FIBA ("February 2019 Letter") (stating that "the amount of required disclosure may overwhelm rather than educate").

473 *See, e.g.*, ASA Letter (stating that the Commission should reaffirm that broker-dealers can address conflicts of interest by disclosing them and obtaining informed consent); Primerica Letter (suggesting that the Commission clarify that broker-dealers can effectively address all material conflicts by providing full and fair disclosure and obtaining customer consent); Morgan Stanley Letter.

client relationship.[474] An investment advisory client must provide informed consent to the adviser's conflicts of interest in the context of the entire relationship, which can be broader than the informed consent provided by a retail customer when making an informed decision to accept or reject a particular recommendation by a broker-dealer. We believe this is appropriate because the investment-adviser client relationship is generally broader and can include, for example, unlimited investment discretion by the investment adviser to conduct securities transactions on behalf of the client. The broker-dealer customer relationship on the other hand is generally transaction-based and the retail customer must accept (or reject) each recommendation by a broker-dealer after the broker-dealer has provided full and fair disclosure as required under the Disclosure Obligation. Thus, in this regard, Regulation Best Interest will more closely align the Disclosure Obligation with the existing requirements for investment advisers, as noted above, but is tailored to the broker-dealer relationship.[475] The Commission believes that the final Disclosure Obligation along with the protections provided by the requirements of Regulation

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474 As discussed in the Fiduciary Interpretation, a client's informed consent can be either explicit or, depending on the facts and circumstances, implicit. *See* Fiduciary Interpretation at Section II.C. Under Regulation Best Interest, however, assuming the retail customer has been provided with full and fair disclosure, the retail customer will be considered to have provided informed consent by *affirmatively* accepting a recommendation.

475 *See* Fiduciary Interpretation (describing an investment adviser's obligation to provide disclosure designed to put a reasonable client in a position to be able to understand and provide informed consent).

Best Interest, including the Care Obligation and Conflict of Interest Obligation, will further serve to enhance the protections available to retail customers.

One commenter recommended that the Commission clarify what a broker-dealer is required to deliver to a retail customer in order to permit the retail customer to make an "informed decision," and asked the Commission to confirm that it does not require a case-by-case analysis of what is reasonable to permit the retail customer to make an informed decision.[476] In addition, other commenters underscored the importance of providing retail customers with sufficient time to review and comprehend the disclosed information prior to making an informed decision about a recommendation.[477] Other commenters questioned whether providing "sufficient information" to enable a retail customer to make an informed decision broadens the Disclosure Obligation beyond "material facts" and "material conflicts."[478]

We have considered the issues raised by the commenters and in the sections that follow are providing guidance on what we believe constitutes "full and fair disclosure" for purposes of

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476 *See, e.g.*, CCMC Letters.

477 *See, e.g.*, Financial Planning Coalition Letter (stating that disclosures should be made prior to the recommendation so a retail customer has sufficient time to review and understand them, as well as to ask questions); CFA August 2018 Letter (stating that if the Commission wants to give investors time to consider the information and make an informed choice disclosure should be provided as soon as reasonably feasible and, when possible, no later than the point of recommendation).

478 *See, e.g.*, IPA Letter (requesting clarification on whether providing sufficient information to enable a retail investor to make an informed decision broadens the disclosure obligation beyond material facts); CCMC Letters.

the Disclosure Obligation, including the form and manner, and the timing and frequency, of the disclosure. Similar to the proposal, in lieu of setting explicit requirements by rule for what constitutes full and fair disclosure of all material facts, we are providing broker-dealers flexibility in determining the most appropriate way to meet the Disclosure Obligation depending on each broker-dealer's specific business practices.

As we noted in the Proposing Release, while we are providing flexibility to broker-dealers to meet the Disclosure Obligation, we continue to be sensitive to the potential that broker-dealers could opt to disclose *all* facts, including those that do not meet the materiality threshold.[479] We are cognizant of the likelihood that some broker-dealers could provide lengthy disclosures that do not meaningfully convey the material facts regarding the scope and terms of the relationship and material facts regarding conflicts of interest, an outcome that could undermine the Commission's goal of facilitating disclosure to assist retail customers in making an informed investment decision. To this end, broker-dealers will only be required to disclose material facts about the scope and terms of the relationship or conflicts of interest.

Although we are adopting the requirement with revisions to require full and fair disclosure of all material facts, we still believe it is important to clarify that broker-dealers' compliance with the Disclosure Obligation will be measured against a negligence standard, not against a standard of strict liability, consistent with the Proposing Release. The Commission has

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479 *Id*.

taken this position in other contexts where full and fair disclosure is required, including under the fiduciary duty under the Advisers Act.[480]

Form and Manner

In the Proposing Release, the Commission noted that it was not proposing to specify by rule the form (e.g., narrative v. graphical/tabular) or manner (e.g., relationship guide or other written communications) of disclosure required under the Disclosure Obligation. The Commission stated that disclosure should be concise, clear and understandable to promote effective communication between a broker-dealer and a retail customer.[481] We also stated that broker-dealers would be able to deliver disclosure required pursuant to Regulation Best Interest consistent with the Commission's guidance regarding electronic delivery of documents.[482] Although we preliminarily believed that broker-dealers should have the flexibility to make

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480 While establishing scienter is a requirement to establish violations of Section 206(1) of the Advisers Act, it is not required to establish a violation of Section 206(2); 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 and footnote 5; *Steadman v. SEC*, 603 F.2d 1126, 1132-34 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). *See also* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628 (Aug. 3, 2007). In its adoption of Rule 206(4)-8 under the Advisers Act, the Commission stated that it would not need to demonstrate that an adviser violating the rule acted with scienter.

481 *See* Proposing Release at 21604, footnote 211.

482 *Id.* at 21604 and footnote 214.

disclosures by any means, as opposed to requiring a standard written document at the outset of the relationship, we stated our belief that any such disclosure should be provided in writing.[483]

Commenters sought further guidance in a number of areas relating to disclosure, including the extent to which the Relationship Summary or other disclosures may satisfy the Disclosure Obligation,[484] the circumstances under which standardized disclosure could be sufficient, as well as how, and the extent to which, disclosures made pursuant to the Disclosure Obligation should be made in writing.[485] In response to comments we are providing additional guidance. We are also reaffirming guidance that we provided in the Proposing Release.

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483 *Id.* at 21604 and footnote 213.

484 *See, e.g.*, Cambridge Letter (arguing that the Relationship Summary and Disclosure Obligation are duplicative requirements); CUNA Mutual Letter (seeking greater clarification regarding the extent to which information provided in other documents could satisfy the Disclosure Obligation); Financial Services Institute August 2018 Letter (arguing that providing the Relationship Summary should be deemed to satisfy the requirements of the broker-dealer's Disclosure Obligation); Morningstar Letter (arguing that due to the brevity of the Relationship Summary, additional broker-dealer disclosures would be necessary); Wells Fargo Letter (recommending that the requirements of the Disclosure Obligation be incorporated into Form CRS).

485 *See, e.g.*, Schwab Letter (arguing that because most recommendations occur over the phone and through various digital means, the Commission should remove the "in writing" requirement and allow firms to determine the best method for disclosure depending on the situation); SIFMA August 2018 Letter (seeking clarification that oral disclosure at the time of the recommendation may be sufficient to satisfy the Disclosure Obligation in certain circumstances). *But see* AARP August 2018 Letter (stating that oral disclosures should never be permitted).

Prescribed Form of Disclosure

As noted in the Proposing Release, we believe it is important to provide broker-dealers with flexibility in determining the most appropriate and effective way to meet the Disclosure Obligation to reflect the structure and characteristics of their relationships with retail customers.[486] Many commenters agreed with this reasoning, arguing that there was a need to preserve flexibility for broker-dealers to comply with the Disclosure Obligation as proposed.[487] Other commenters believed, however, that the proposed Disclosure Obligation gave broker-dealers too much discretion.[488]

After careful consideration of these comments, the Commission has decided not to require any standard written disclosures (other than the Relationship Summary) at this time. Although we recognize the potential value to retail customers of standardizing the disclosures required pursuant to the Disclosure Obligation, we believe that retail customers can derive value from disclosures that accommodate the structure and characteristics of the particular broker-

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486 *See* Proposing Release at 21604.

487 *See, e.g.*, Prudential Letter; SIFMA August 2018 Letter; TIAA Letter; UBS Letter.

488 *See, e.g.*, Better Markets August 2018 Letter (arguing that proving broker-dealer discretion in this area will virtually assure a failure to communicate helpfully with investors); CFA August 2018 Letter (arguing that the flexibility the Commission provides will result in disclosure that does not effectively convey key information). *See also* Morningstar Letter (supporting the expansion of disclosures, but arguing that "publicly available disclosures with a standard taxonomy work best because they empower third parties such as "fintech" and "reg-tech" firms to analyze and contextualize critical information and amplify a call to action for ordinary investors").

dealer. On balance, we recognize the wide variety of business models and practices and we continue to believe it is important to provide broker-dealers with flexibility to enable them to better tailor disclosure and information that their retail customers can understand and may be more likely to read at relevant points in time, rather than, for example, mandating a standardized all-inclusive (and likely lengthy) disclosure.[489]

We disagree that flexibility will prevent investors from obtaining information necessary to make an informed investment decision and do not believe that requiring a standard written disclosure beyond the Relationship Summary is necessary at this time. We emphasize, however, that the adequacy of the disclosure will depend on the facts and circumstances. We intend to

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[489] With respect to the length of disclosure documents, investor testing of proposed Form CRS examined retail investors' likelihood of reading only longer documents (such as Form ADV Part II or an account opening agreement), only a short document (Form CRS), both, or neither when choosing a financial professional, account type or firm. Although the context was specific to Form CRS and the retail investor's initial determination regarding a financial professional, account type or firm, the survey suggests that retail investors may be more likely to read either both longer and shorter disclosures or just shorter disclosures. *See* RAND 2018 ("Whereas Figure 2.20 shows that half of all investors reported having reviewed neither a Form ADV nor an account opening agreement in the past and another 20 percent reported not knowing whether they had ever done so, Figure 2.21 shows that about 70 percent of all respondents and of all investors reported that they would be likely to read either both types of documents or only the Relationship Summary when choosing a financial professional in the future. Just 2 percent of investors and 1 percent of noninvestors reported being likely to read only the longer documents, whereas 29 percent of investors and 13 percent of noninvestors were likely to read only the Relationship Summary." More specifically, Figure 2.21 shows that over 40% of all respondents indicated they would read both and under 30% indicated that they would read only the Relationship Summary.)

evaluate broker-dealer disclosure practices in response to Regulation Best Interest over time to determine whether additional disclosure initiatives may be appropriate.

Relying on Other Disclosures and Standardized Documents

In the Proposing Release, we described how the Disclosure Obligation builds upon the requirements of Form CRS and the disclosures in the Relationship Summary.[490] We also stated that we anticipated that broker-dealers may elect to use other documents to satisfy elements of the Disclosure Obligation, such as an account agreement, a relationship guide, or a fee schedule.[491]

Several commenters requested guidance on their ability to use other documents to meet the requirements of the Disclosure Obligation. For example, some commenters recommended that the Commission harmonize the Disclosure Obligation with the broad, firm-level disclosure obligations of Form CRS so that firms can use the Relationship Summary to help satisfy the Disclosure Obligation.[492] Commenters also recommended that broker-dealers should be permitted to satisfy the Disclosure Obligation by using standardized language generally to

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490 *See* Proposing Release at 21600.

491 *See id*. at 21605.

492 *See, e.g.*, Cambridge Letter (recommending that providing the Form CRS should fulfill the broker-dealer's Disclosure Obligation under Regulation Best Interest); ACLI Letter (noting that a single disclosure fulfilling Regulation Best Interest and Form CRS would reduce the disclosure burdens and increase the likelihood consumers will read the required information); FSI August 2018 Letter; Mutual of America Letter; Northwestern Mutual Letter; IPA Letter; Transamerica August 2018 Letter; NAIFA Letter.

describe the broker-dealer's products and services available to their retail customers and related conflicts of interest, including the ranges of remuneration payable to a broker-dealer in connection with its recommendation of different products.[493] Several commenters also suggested that the Commission should clarify that the Disclosure Obligation should not apply where an existing disclosure regime already exists.[494] Similarly, other commenters recommended that the Commission clarify whether broker-dealers could meet the Disclosure Obligation by referencing information required to be disclosed pursuant to other regulatory requirements such as FINRA disclosure rules.[495]

After careful consideration of the comments, the Commission is providing guidance to permit a broker-dealer to utilize existing disclosures and standardized documents, such as a product prospectus, relationship guide, account agreement, or fee schedule to help satisfy the Disclosure Obligation. The Commission recognizes that broker-dealers are subject to disclosure

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493 *See, e.g.*, LPL August 2018 Letter (recommending that all investors be provided with general disclosures setting forth the ranges of remuneration payable to broker-dealers in connection with its recommendations of different products); Committee of Annuity Insurers (urging the Commission to clarify that a broker-dealer can satisfy the Disclosure Obligation through disclosure describing products and services available to its retail customers and need not provide a disclosure particularized to a recommendation).

494 *See, e.g.*, SIFMA August 2018 Letter (asking the Commission to clarify that the Disclosure Obligation does not apply in contexts where there is an existing regime, such as for equity and debt research); Transamerica August 2018 Letter (recommending that the Commission recognize that existing disclosure regimes suffice to meet certain disclosure requirements).

495 *See, e.g.*, Transamerica August 2018 Letter (stating that the disclosure obligation should expressly take into consideration existing disclosures).

requirements other than the Disclosure Obligation and Form CRS, and believes utilizing such existing disclosures where appropriate is a reasonable and cost-effective way to satisfy the requirements of the Disclosure Obligation, and can also help avoid duplicative or voluminous disclosure by not requiring the creation of new disclosure documents.[496] We recognize also that in many instances, information necessary to satisfy the Disclosure Obligation may be broadly applicable to a broker-dealer's retail customers, and therefore the use of standardized disclosure may be appropriate.

However, while broker-dealers may choose to standardize certain forms of their disclosure, whether such materials would be sufficient to satisfy the Disclosure Obligation will depend on the facts and circumstances.[497] For example, disclosures may need to be tailored to a particular recommendation if the standardized disclosure does not sufficiently identify the material facts about a conflict of interest presented by a particular recommendation. Accordingly,

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496 *See* Proposing Release at 21599, footnotes 175 and 176. For example, broker-dealers must disclose information about a transaction on trade confirmations pursuant to Exchange Act Rule 10b-10. 17 CFR § 240.10b-10. *See also* Morgan Stanley Letter (noting that the securities laws and FINRA rules already require firms to provide significant disclosures to clients at natural touchpoints in the client relationship).

497 Similarly, we also note that a number of broker-dealers are modeling their disclosure of fees other than transaction-based fees on the NASAA Schedule of Miscellaneous Account and Service Fees. *See* NASAA August 2018 Letter. A broker-dealer may use this schedule to comply in part with its obligation to disclose fees and costs pursuant to the Disclosure Obligation. We note, however, that the NASAA Schedule may recommend the disclosure of certain fees that may not be required under the Disclosure Obligation depending on the facts and circumstances, for example those that are not "material facts" for purposes of Regulation Best Interest.

a broker-dealer remains responsible for disclosing all material facts relating to the scope and terms of the relationship with the retail customer (as discussed above), as well as all material facts relating to conflicts of interest that are associated with a recommendation whether or not the firm relies on other materials to fulfill that obligation.

With regard to commenters' request that the Relationship Summary be considered sufficient to satisfy the Disclosure Obligation, we note that the Relationship Summary will provide succinct information and is designed to assist retail investors with the process of deciding whether to engage, or to continue to engage, a particular firm or financial professional, deciding whether to establish or continue to maintain a brokerage or investment advisory relationship, and asking questions and easily finding additional information. We recognize that additional details regarding many of the topics (e.g., services, fees and conflicts of interest) would in many cases be necessary to satisfy the Disclosure Obligation. Thus, although a broker-dealer could use a Relationship Summary and other standardized disclosures about its products and services to help satisfy the Disclosure Obligation, these disclosures may not be sufficient to satisfy the Disclosure Obligation. Whether the Relationship Summary standing alone, or any additional or existing disclosures, satisfy any of these required disclosures in full would depend on the facts and circumstances. In most instances, broker-dealers will need to provide additional information beyond that contained in the Relationship Summary in order to satisfy the Disclosure Obligation.

In Writing

We proposed requiring that disclosures be provided in writing.[498] We also stated that requiring written disclosures would help 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.[499] We also stated that the "in writing" requirement could be satisfied either through paper or electronic means consistent with existing Commission guidance on electronic delivery of documents. We also provided guidance on how broker-dealers could comply with the "in writing" requirement when recommendations are given over the telephone.[500]

A number of commenters supported the "in writing" requirement.[501] Other commenters, however, recommend that the Commission also permit the use of oral disclosure.[502] For example, several commenters recommend that the Commission permit broker-dealers to orally

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498 *See* Proposing Release at 21604.

499 *Id.*

500 *Id.*

501 *See, e.g.*, Vanguard Letter (recommending that the Commission require a consolidated written disclosure of all material conflicts); CFA August 2018 Letter.

502 *See* Schwab Letter (recommending that the Commission eliminate the "in writing" requirement and allow firms to design and document the best method depending on the situation); SIFMA August 2018 Letter; TIAA Letter. *But see* AARP August 2018 Letter (stating that oral disclosures should never be permitted).

disclose information to their customers provided they later follow-up in writing.[503] Other commenters highlighted concerns associated with such oral disclosure.[504]

After carefully considering the comments, we are adopting the "in writing" requirement as proposed, subject to discussion in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*. As stated above, we believe that retail customers would benefit from receiving a written disclosure to assist their investment decisions and form the basis of an informed investment decision.[505] However, we also believe that broker-dealers require

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503 *See* PIABA Letter (recommending that the Commission allow broker-dealers to discharge their disclosure obligations by: (i) orally explaining the relationship, any conflicts, how the broker-dealer is paid, and the features, benefits and risks of the recommendation; and (ii) confirming the discussion by letter or email, which is signed or confirmed as being accurate by the customer, and retained in customer's file); SIFMA August 2018 Letter (recommending that the Commission clarify that oral disclosure at the time of the recommendation may satisfy the Disclosure Obligation if: (1) the associated person documents that the oral disclosure was made, or (2) the firm provides written disclosure after the trade); USAA Letter (suggesting that the Commission could allow oral product-level disclosures, while providing the client the choice to request confirming disclosure in writing at her option).

504 *See* Edward Jones Letter (expressing concern that the Commission is implying that a dual-registrant would need to provide an oral point of sale disclosure regarding the capacity in which it is acting when it makes a recommendation, and that such oral disclosure would be difficult to supervise and of little value); CCMC Letters (stating that a dual-registrant should not have to make an oral disclosure of the capacity for each and every conversation it has with retail customers).

505 One commenter stated that certain foreign laws do not permit firms to provide their customers with written materials prior to entering into a contractual relationship. *See* FIBA February 2019 Letter. In response, we note that the Disclosure Obligation requires disclosure to be provided prior to or at the time of the recommendation and is not tied to a contractual relationship. In addition, the staff will continue to evaluate the application of

flexibility to make proper written disclosures to their customers. Accordingly, the Commission is not requiring a specific form or method of written disclosure.

Although we are requiring that disclosure be made "in writing," we recognize that a broker-dealer may need to supplement, clarify or update written disclosure it has previously made before it provides a retail customer with a recommendation. For instance, as we stated in the Proposing Release, we recognized that broker-dealers may provide recommendations by telephone and offer clarifying disclosure orally in some instances subject to certain conditions,[506] such as a dual-registrant informing a retail customer of the capacity in which the dual-registrant is acting in conjunction with a recommendation.[507] In such instances, we believe that it may be necessary as a practical matter to provide oral disclosure of a material fact to supplement, clarify, or update written disclosure made previously.[508] Therefore, firms may make oral disclosures

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the Disclosure Obligation in circumstances such as the one raised by this commenter. Interested parties are invited to provide further feedback on issues involving non-U.S.-resident retail customers.

506 *See* Proposing Release at 21604, footnote 213.

507 *See id*. at 21605, footnote 216. We stated that a broker-dealer could orally clarify the capacity in which it is acting at the time of the recommendation if it had previously provided written disclosure to the retail customer beforehand disclosing its capacity as well as the method it planned to use to clarify its capacity at the time of the recommendation.

508 For more discussion on guidance relating to updating disclosures, see Section II.C.1.d, Disclosure Obligation, *Updating Disclosure*.

under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*.[509]

When making such an oral disclosure, firms must maintain a record of the fact that oral disclosure was provided to the retail customer.[510] We are not explicitly requiring broker-dealers to create a record documenting the *substance* of the oral disclosure itself, but rather a record of the fact that such oral disclosure was made.[511] This record should include documentation sufficient to demonstrate that disclosure was made to the retail customer, which could include, for example, recordings of telephone conversations or contemporaneous written notations. Nonetheless, although it is not required by Regulation Best Interest, as a best practice we encourage broker-dealers that make oral disclosures to subsequently provide to their retail customers in a timely manner written disclosure summarizing the information conveyed orally.

Plain English

In the Proposing Release, we stated that broker-dealers 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

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509 *See* Section II.C.1, Disclosure Obligation, *Oral Disclosure or Disclosure After a Recommendation*.

510 *See* Section II.D.

511 *See* Section II.C.1, Disclosure Obligation, *Oral Disclosure or Disclosure After a Recommendation*.

negatives.[512] Similarly, several commenters recommended that whatever format broker-dealers use for their disclosure, they should be written in plain English and easy to understand.[513] Accordingly, although it is not required, the Commission encourages broker-dealers to use plain English in preparing any disclosures they make in satisfaction of the Disclosure Obligation.

Electronic Delivery

In the Proposing Release, we took the position that broker-dealers could deliver written disclosures required by Regulation Best Interest in accordance with the Commission's existing guidance regarding electronic delivery of documents.[514] This framework consists of the

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512 Proposing Release at 21604, footnote 213.

513 *See* State Attorneys General Letter (stating that all disclosures must be in plain language and easily understood by investors); CFA Institute (recommending that the Commission require a clear English listing of all conflicts of interest in which a broker-dealer engages). One commenter requested that the Commission consider clarifying that the Plain English standard in the Disclosure Obligation is not an English-only requirement to address the needs of certain non-U.S. customers. *See* FIBA February 2019 Letter. In response, we note that any disclosure should be made consistent with Plain English principles.

514 *See* Proposing Release at 21604. We cited to a number of prior Commission releases on electronic delivery in the Proposing Release, including Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Exchange Act Release No. 37182 (May 9, 1996), 61 FR 24644 (May 15, 1996) ("1996 Release") (providing Commission views on electronic delivery of required information by broker-dealers, transfer agents and investment advisers) and Use of Electronic Media, Exchange Act Release No. 42728 (Apr. 28, 2000), 65 FR 25843 (May 4, 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).

following elements: (1) notice to the investor that information is available electronically; (2) access to information comparable to that which would have been provided in paper form and that is not so burdensome that the intended recipients cannot effectively access it; and (3) evidence to show delivery (i.e., reason to believe that electronically delivered information will result in the satisfaction of the delivery requirements under the federal securities laws).[515] We have furthermore clarified that one method to satisfy the evidence of delivery element is to obtain informed consent from investors.[516]

Several commenters agreed with this approach.[517] These commenters typically supported the use of electronic disclosure and recommended various methods (e.g., hyperlinks to web-based documents) but recommended paper delivery as the default option.[518] Other commenters

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515 *See* 1996 Release at 24646-47; *see also* Relationship Summary Proposing Release at 21454.

516 *See* 2000 Release at 25845-46 (clarifying how market intermediaries and other market participants can obtain consent for electronic delivery).

517 *See, e.g.*, CFA August 2018 Letter (stating that giving firms discretion to choose the delivery mechanism would all but ensure that many investors would never see the disclosures); AARP August 2018 Letter (recommending that the Commission prohibit firms from solely providing electronic access to disclosures and require delivery of paper copies).

518 *Id. See also* LPL August 2018 Letter (noting that modern communication practices underscore the need for the Commission to provide more flexibility to broker-dealers to satisfy their document delivery obligations; and requesting that the Commission confirm that broker-dealers can deliver disclosures in compliance with existing guidance regarding electronic delivery of documents (which requires paper delivery as a default)).

recommended permitting electronic delivery for required disclosures.[519] While investor testing on the proposed Relationship Summary indicated that some retail investors generally support some form of electronic copies, most participants in the study "generally liked having a paper version of the Relationship Summary."[520] Similarly, as stated in the Form CRS adopting release, the IAC has cited one study indicating that nearly half of investors (49%) still prefer to receive paper disclosures through the mail, compared with only 33% who prefer to receive disclosures electronically, either through email (27%) or accessing them online (6%).[521]

After considering investor testing results and commenters' concerns and recommendations, the Commission reaffirms the application of existing Commission guidance relating to paper and electronic delivery of disclosure documents to broker-dealers in meeting the Disclosure Obligation. Specifically, we believe that broker-dealers should be able to satisfy the

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519 *See, e.g.*, IPA Letter (urging the Commission to confirm that all required disclosures may be delivered electronically); *see also* AXA Letter (urging the Commission to encourage the use of appropriate electronic disclosures, which can make information available to consumers more quickly and in a more digestible format); Prudential Letter (recommending that electronic delivery be deemed to comply with the Disclosure Obligation).

520 *See* RAND 2018.

521 Relationship Summary Adopting Release at Section II.D.3.a (citing Investor Advisory Committee, *Recommendation of the Investor as Purchaser Subcommittee: Promotion of Electronic Delivery and Development of a Summary Disclosure Document for Delivery of Investment Company Shareholder Reports* (Dec. 7, 2017), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-promotion-of-electronic-delivery-and-development.pdf (citing FINRA Investor Education Foundation, "Investors in the United States 2016," December 2016, *available at* http://bit.ly/2hMrppX).

Disclosure Obligation by using electronic delivery.[522] However, if a broker-dealer is providing its customers with electronic delivery (upon their consent) it cannot solely offer electronic delivery and must make paper delivery available, upon request. Both Regulation Best Interest and Form CRS require firms to provide electronic delivery of documents within the framework of the Commission's existing guidance regarding electronic delivery.[523]

d. Timing and Frequency

We proposed requiring broker-dealers to provide the disclosures required by the Disclosure Obligation "prior to or at the time of" the recommendation. We noted 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.[524] In cases where a broker-dealer determines that disclosure may be more effectively be provided in an initial, more general disclosure (such as a relationship guide) followed by specific information in a subsequent disclosure that is provided at a later time, the initial disclosure would address when and how a broker-dealer would provide more specific information regarding the material fact or conflict in

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522 *See* 1996 Release (stating that "the Commission believes that broker-dealers . . . similarly should have reason to believe that electronically delivered information will result in the satisfaction of the delivery requirements under the federal securities laws. Thus, whether using paper or electronic media, broker-dealers . . . should consider the need to establish procedures to ensure that applicable delivery obligations are met"); *see also* 2000 Release.

523 *See* Relationship Summary Adopting Release, Section II.C.3.

524 *See* Proposing Release at 21605.

a subsequent disclosure. We stated also that in circumstances where a broker-dealer determines to provide an initial, more general disclosure (such as a relationship guide) followed by specific information in a subsequent disclosure that is provided after the recommendation (such as a trade confirmation), the initial disclosure must address when and how a broker-dealer would provide more specific information regarding the material fact or conflict in a subsequent disclosure (e.g., after the trade in the trade confirmation).[525] We also stated that 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." We noted also that whether there is sufficient

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525 The Commission has granted exemptions to certain dual-registrants, subject to a number of conditions, from the written disclosure and consent 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, Advisers Act Release No. 4596 (Dec. 28, 2016); In the matter of UBS Financial Services, Inc., Advisers Act Release No. 4597 (Dec. 28, 2016); In the matter of Wells Fargo Advisors, LLC, Wells Fargo Advisors Financial Network, LLC, Advisers Act Release No. 4598 (Dec. 28, 2016).

disclosure in both the initial disclosure and any subsequent disclosure would depend on the facts and circumstances.[526]

Several commenters supported the Commission's proposal to require broker-dealers to make disclosure prior to or at the time of the recommendation, but disagreed about the precise timing with which disclosure should be provided.[527] For example, some commenters recommended that the Commission require or allow broker-dealers to meet the Disclosure Obligation prior to or at account opening.[528] Similarly, several commenters recommended that the Commission require broker-dealers to provide disclosure prior to a recommendation or investment decision.[529] Specifically, commenters recommended that the Commission require

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526 *See* Proposing Release at 21605.

527 *See, e.g.,* CFA August 2018 Letter (stating that any information that can be provided before the transaction is entered into should be provided to give investor time to consider it); AARP August 2018 Letter (stating that all key disclosures should be made significantly in advance of an investment decision; disclosure made at the time of or immediately prior to investing is not adequate); Bank of America Letter (stating that disclosure of material conflicts of interest can be satisfied in advance of a particular recommendation on a one-time basis); Pacific Life August 2018 Letter (stating that disclosure of material conflicts of interest must be disclosed at or prior to the point of sale or at the time the recommendation is made); FPC Letter.

528 *See, e.g.*, TIAA Letter (recommending that the Commission require firms to meet their Regulation Best Interest and CRS disclosure obligations at or before the point the investor: (i) opens a brokerage account; or (ii) engages the broker-dealer to provide advice services (including for recommendations provided by phone)).

529 *See, e.g.,* Better Markets August 2018 Letter (stating that disclosure should be provided in a timely fashion so investors have a meaningful opportunity to read, digest, understand, and discuss them); FPC Letter; AARP August 2018 Letter.

disclosures to be made with enough time prior to a recommendation that a retail customer has sufficient time to review and understand them, as well as ask questions.[530]

Several other commenters, however, recommended that the Commission clarify whether broker-dealers could meet the Disclosure Obligation at the point of sale[531] or after a recommendation is made.[532] Conversely, several commenters recommended that the

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530 *See, e.g.*, NAIFA Letter (recommending that disclosure be provided at or before the time of a recommendation because it helps consumers better understand and evaluate the recommendations they receive and preserves flexibility for professionals who may be interacting with clients of various levels of financial sophistication, duration of relationship, and investment history); CFA August 2018 Letter (recommending that transaction-specific information should be provided, whenever possible, at the point of recommendation rather than at the point of sale); Groom Letter (recommending that the Commission require disclosure of material conflicts of interest related to investing plan distribution proceeds at the inception of any discussions of the matter); PIABA Letter (recommending that the Commission require firms to provide specific charges prior to or at the time the recommendation is made); FPC Letter (stating that disclosures should be made prior to the recommendation so the retail customer has sufficient time to review and understand them, as well as to ask questions); Better Markets August 2018 Letter; AARP August 2018 Letter; Bank of America Letter.

531 *See* Pacific Life August 2018 Letter (stating that material conflicts of interest must be disclosed at or prior to the point-of-sale or at the time the recommendation is made).

532 *See, e.g.*, LPL August 2018 Letter (suggesting that the Commission permit a broker-dealer to satisfy the Disclosure Obligation by directing an investor in writing to review the recommended product's offering documents, along with hyperlinks to those documents, prior to the recommendation or shortly thereafter via a trade confirmation); SIFMA August 2018 Letter (recommending that the Commission confirm that firms would be permitted to provide disclosures on a website or on a post-trade basis, provided customers have been informed in advance of the timing of those disclosures).

Commission clarify that it will not require point of sale or point of recommendation disclosure obligations.[533]

After carefully considering the comments received, we are providing our view on what it means for broker-dealers to provide the required disclosures in writing "prior to or at the time of" the recommendation. As with the "form and manner" of making disclosures, the Commission continues to believe that broker-dealers should have flexibility with respect to the "timing and frequency" of providing disclosure to determine the most appropriate and effective way to meet the Disclosure Obligation. Accordingly, the Commission has decided not to provide any prescriptive requirements for the timing and frequency of written disclosures, other than requiring disclosure prior to or at the time of the recommendation.

In order to make an informed decision about a securities recommendation, retail customers must have appropriate information at the time or before a recommendation is made.

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533 *See, e.g.*, SIFMA August 2018 Letter (requesting the Commission clarify that there is no requirement for a point of sale or point of recommendation disclosure, as such a requirement would be unworkable for the industry); Morgan Stanley Letter (noting that point-of-sale disclosures pose operational issues and may not afford clients sufficient time to adequately consider and understand them); HD Vest Letter (recommending that the Commission not mandate written point of recommendation or point of sale disclosure); Prudential Letter (requesting that the Commission clarify that it is not mandating a point of sale or point of recommendation disclosure obligation). *But see* NASAA August 2018 Letter (stating that only a transaction-by-transaction disclosure obligation will ensure that broker-dealers are meeting their "best interest" duties and provide investors the level of protection they deserve); AARP August 2018 Letter (recommending that the Commission require firms to disclose their fees any time a recommendation is made).

Being in possession of relevant information gives investors the tools with which to judge the merits of acting on a particular recommendation. As stated in the Proposing Release, the Commission believes that broker-dealers should provide retail customers 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.[534] Similarly, the Commission believes that broker-dealers should not provide information 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).[535] Nevertheless, in order to provide broker-dealers the flexibility to determine how and when to make relevant disclosures pursuant to the Disclosure Obligation, we are not mandating a requirement that disclosures be made within a certain timeframe preceding a recommendation. However, we continue to encourage broker-dealers to consider whether it would be helpful to repeat or highlight disclosures already made pursuant to the Disclosure Obligation at the time of the recommendation.

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534 Proposing Release at 21605.

535 *Id*.

We are also clarifying the ability of a broker-dealer to supplement, clarify, or update information *after* making a recommendation.[536] In particular, if a broker-dealer determines to disclose information, in part, after the recommendation, such as in a prospectus or trade confirmation, that disclosure may be used to supplement, clarify, or update the initial, general disclosure. For example, any necessary information in a product offering document, such as information about product risks or fees, may be provided in accordance with existing disclosure mechanisms that occur after a transaction, such as the delivery of a trade confirmation or a prospectus, private placement memorandum, or offering circular.[537] However, the broker-dealer must comply with the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*, in order to make any such disclosure after the recommendation.

Layered Disclosure

We proposed to require broker-dealers to provide disclosure prior to or at the time of the recommendation but gave guidance on a number of approaches they could take to achieve this requirement, including providing layered disclosure, in which more general information is

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536 *See id*. In the proposal, we noted that there may be material information that the broker-dealer may not be in a position to disclose at or prior to the recommendation that may be revealed following the transaction, such as the final transaction information contained in a trade confirmation.

537 In instances where a recommended transaction is not acted upon by the retail customer, and therefore there is no subsequent delivery of disclosure otherwise required by the transaction, the fact that such information is not provided would not be a violation of the Disclosure Obligation.

supplemented by more detailed information provided either at the same time or subsequently.[538] We received a number of comments supporting our proposed guidance concerning a layered approach to the Disclosure Obligation.[539] In addition, investor testing illustrates that many retail investors support a layered approach as well.[540]

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538 *See* Proposing Release at 21605 (suggesting the Disclosure Obligation could be satisfied, for example, at multiple points in the relationship or through a layered approach to disclosure, such as an initial disclosure conveying more general information regarding the material fact or conflict followed by more specific information in a subsequent disclosure).

539 *See, e.g.*, Commonwealth Letter (supporting a layered disclosure approach that includes (i) the Relationship Summary at the inception of the relationship; (ii) the traditional disclosures included in account-opening agreements; (iii) product-specific point-of-sale disclosures (*e.g.*, prospectuses and alternative investment offering documents); and (iv) more detailed disclosures on the firm's website); IRI Letter (supporting a principles-based disclosure regime, which leverages the benefits of layered disclosure to combat information overload); Morgan Stanley Letter (concurring with the Commission's proposed layered approach to disclosure of material facts regarding the scope of the relationship with the client and fees, as well as material conflicts of interest associated with the recommendation); Stifel Letter; Mass Mutual Letter; Triad Advisors Letter; Investacorp Letter; Ladenburg Letter.

540 *See, e.g.,* Study Regarding Financial Literacy Among Investors As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, August 2012 at iv. A key finding of the SEC staff's 917 study was that Investors favor "layered" disclosure and, wherever possible, the use of a summary document containing key information about an investment product or service. That study described layered disclosure as an "approach to disclosure in which key information is sent or given to the investor and more detailed information is provided online and, upon request, is sent in paper or by e-mail." *See* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8998 (Jan. 13, 2009). This layered approach is "intended to provide investors with better ability to choose the amount and type of information to review, as well as the format in which to review it (online or paper)." *Id.* Other studies that considered the use of

We have considered these comments and results of investor testing and will continue to permit broker-dealers to use a layered approach to disclosure. We acknowledge that different investors have different preferences for the type and length of disclosures they receive, and that some investors may not read additional information provided in any particularized disclosure that supplements initial, standardized disclosure. Nonetheless, we believe that permitting broker-dealers to provide their retail customers with a standardized summary of information supplemented by more particularized information will help avoid the likelihood that retail customers receive a single, potentially voluminous disclosure document, and enable the many investors who prefer a shorter, summary document to have it available to them, with additional information available should they wish to have it. This approach to layering information is also consistent with our concurrent effort in Form CRS to provide retail investors with high level

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hyperlinks for layered disclosure in proposed Form CRS suggested that retail investors are generally interested in receiving additional information, but recognized the possibility that retail investors may not click on a hyperlink. *See, e.g.*, RAND 2018 (finding 58% of participants selecting "very likely" and another 32% selecting "somewhat likely" to click on a hyperlink relating to fees; although no other potential hyperlink generated a majority with "very likely" usage, other potential hyperlinks concerning services, conflicts and investor education generated a majority when combining responses of "very likely" and "somewhat likely" to click on the hyperlink). *See also* Kleimann Communication Group, Inc., *Report on Development and Testing of Model Client Relationship Summary, Presented to AARP and Certified Financial Planner Board of Standards, Inc.* (Dec. 5, 2018), *available at* https://www.sec.gov/comments/s7-07-18/s70718-4729850-176771.pdf (indicating that while some participants were interested in additional information, others admitted they would not follow the links because it was extra effort, they were uninterested, or the link did not itself suggest what would be there).

information and context concerning key material facts, supplemented by additional layers of information regarding their relationship.

We also continue to believe that broker-dealers should have flexibility in determining when to make disclosures and whether, in light of their retail customer base, certain material facts would be more effectively conveyed in a more general manner in an initial written disclosure accompanied or followed by more specific information in a separate disclosure. Similarly, we believe that providing broker-dealers with flexibility to best target their disclosures to their particular retail customer base will increase the likelihood that investors will view them.

The Commission is not prescribing specific procedures obligating broker-dealers to fulfill the Disclosure Obligation in a particular way. Rather, Regulation Best Interest as adopted provides broker-dealers with flexibility to provide disclosures that are consistent with the various ways in which broker-dealers may already provide disclosure to their customers.[541] This could include, for example, providing multiple or "layered" disclosures either initially or over time, but that in total constitute full and fair disclosure of the information required by the Disclosure Obligation. While we are not setting forth a prescriptive approach regarding exactly when disclosures should be made as suggested by some commenters, we believe that a broker-dealer may determine that certain disclosures are most effective if they are made at multiple points of

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[541] *See* Proposing Release at 21605.

the relationship, or alternatively, certain material facts may be conveyed in a more general manner in an initial written disclosure accompanied or followed by more specific information.[542]

Updating Disclosures

Several commenters recommend that the Commission clarify under what circumstances a broker-dealer would be required to update prior disclosures made pursuant to the Disclosure Obligation.[543] Among the suggestions are to only require broker-dealers to update their disclosures when there are material changes to the disclosed information;[544] require broker-dealers to update their disclosures at least 30 days before raising or imposing new fees;[545] and require broker-dealers to update their disclosures when changes are made, as well as annually.[546]

The Commission has carefully considered the commenters' suggestions and is providing guidance on a broker-dealer's duty to update disclosures made to customers under Regulation

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542 *See id*.

543 *See, e.g.*, LPL August 2018 Letter (recommending that the Commission provide additional guidance with respect to the updating and amendment requirements that apply to the Disclosure Obligation); CFA Institute Letter (recommending that the Commission require broker-dealers to provide updated disclosures at least 30 days before raising or imposing new fees); Bank of America Letter (recommending that the Commission require firms to update existing disclosures when there are changes to material conflicts of interest, as well as annually); NAIFA Letter (recommending that the Commission not require regular disclosure (*e.g.*, quarterly, annual, etc.) of any new information items, unless the information has materially changed).

544 *See* NAIFA Letter.

545 *See* CFA Institute Letter.

546 *See* Bank of America Letter.

Best Interest. The Disclosure Obligation requires broker-dealers to provide their retail customers with full and fair disclosure of material facts related to several aspects of their relationship with their customers. Therefore, a broker-dealer cannot provide customers with full and fair disclosure if the disclosures contain materially outdated, incomplete, or inaccurate information. Additional disclosure will be necessary 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).[547] Therefore, a broker-dealer's duty to update disclosures made to its customers under Regulation Best Interest is based on the facts and circumstances.

While we are not prescribing an explicit timeframe in which required updates must be made, generally the Commission encourages broker-dealers to update their disclosures to reflect material changes or inaccuracies as soon as practicable, and thus generally should be no later than 30 days after the material change; in the meantime, broker-dealers are encouraged to provide, supplement, or correct any written disclosure with oral disclosure as necessary prior to or at the time of the recommendation.[548] However, if updated information is to be provided

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547 *See* Proposing Release at 21605.

548 The 30-day period aligns with other requirements to update disclosures in similar contexts. For instance, NASD Notice to Members 92-11, Fees and Charges for Services (Feb. 1992) states that its member firms need to provide written notification to customers of all service charges when accounts are opened, and . . . written notification at least 30 days prior to the implementation or change of any service charge. Failure to do so could

either orally, or after a recommendation, such disclosure must be made under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*.

2. Care Obligation

We proposed the Care Obligation to 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. As we indicated in the Proposing Release, the Care Obligation was intended to incorporate and enhance existing suitability requirements applicable to broker-dealers under the federal securities laws by, among other

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be construed as conduct inconsistent with just and equitable principles of trade under FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).

things, imposing a "best interest" requirement that will require a broker-dealer to not place its own interest ahead of the retail customer's interest, when making recommendations.[549]

Commenters generally supported the proposed Care Obligation, including its principles-based approach, but many commenters requested additional guidance or clarification on how a broker-dealer could satisfy the Care Obligation under different circumstances and regarding specific products.[550] Relatedly, several commenters requested further guidance regarding the role of costs and other relevant factors when making a best interest determination,[551] while other commenters expressed concern over the usage of the term "prudence"[552] or expressed concern that Regulation Best Interest is not a major change from FINRA's suitability rule.[553] Numerous commenters also requested clarification on the meaning and scope of "reasonably available alternatives" and "otherwise identical securities," including how the phrase "reasonably available alternatives" would apply in situations where a broker-dealer operated in an open architecture

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549 As discussed in the Fiduciary Interpretation, the duty of care of the investment adviser's fiduciary duty includes a duty to provide investment advisory services that are in the best interest of the client. *See* Fiduciary Interpretation at footnote 34.

550 *See, e.g.*, NASAA August 2018 Letter; Cambridge Letter; BlackRock Letter.

551 *See, e.g.*, Wells Fargo Letter; Primerica Letter; CFA Institute Letter.

552 *See, e.g.*, BISA Letter; Raymond James Letter; Transamerica August 2018 Letter.

553 *See, e.g.*, CFA August 2018 Letter (stating "[n]owhere does the Commission explain how the standard differs from, or even whether it improves upon, the existing suitability standard under FINRA rules"); AFL-CIO April 2019 Letter (stating "that the intent of [proposed Regulation Best Interest] is to codify, rather than enhance, protections investors currently receive under FINRA's suitability standard").

environment,[554] or maintained a limited product menu such as where broker-dealers limited available offerings to proprietary products.[555] Finally, several commenters recommended the Commission include other factors in building a retail customer's investment profile, such as longevity risk,[556] market risk,[557] or income profile.[558]

We are adopting the Care Obligation substantially as proposed, but with certain modifications and additional guidance to address comments. As discussed in more detail below, in response to comments, we are revising the Care Obligation to remove the term "prudence," as we have concluded that its inclusion creates legal uncertainty and confusion, and it is redundant of what we intended in requiring a broker-dealer to exercise "diligence, care, and skill," and its removal does not change the requirements under the Care Obligation. Accordingly, the Care Obligation will require broker-dealers to "exercise reasonable diligence, care, and skill" to meet the three components of the Care Obligation.

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554 For purposes of this requirement, we use the term "open architecture" to mean a firm's product menu that includes both third-party and proprietary products, or as a concept wherein a firm offers a large range of products to their retail customers that are not limited, for example, to a small list of approved managers or funds (i.e., a product menu that is not limited to proprietary products or otherwise constrained to certain retail customers or registered representatives). *See generally* FINRA 2013 Conflicts Report; Morgan Stanley Letter.

555 *See, e.g.*, Fidelity Letter; ICI Letter; LPL August 2018 Letter; SIFMA August 2018 Letter; Prudential Letter; Morningstar Letter.

556 *See, e.g.*, CCMC Letters; Lincoln Financial Letter; Pacific Life August 2018 Letter.

557 *See, e.g.*, Jackson National Letter.

558 *See, e.g.*, Lincoln Financial Letter.

In addition, after careful consideration of the comments received, we are expressly adding cost to the rule text as a factor that a broker-dealer must consider in fulfilling the Care Obligation. While certain commenters expressed concerns about the prominence of cost and how cost would be balanced against other factors under the Care Obligation,[559] other commenters supported incorporating cost into the rule text.[560] As noted in the Relationship Summary Adopting Release, participants in investor testing and roundtables also overwhelmingly supported including fees in the Relationship Summary, and believed that the "fees and costs" section was the most important for determining which type of investment accounts and services are right for that person.[561] We believe that while the factors that a broker-dealer should understand and consider when making a recommendation may vary depending

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559 *See, e.g.*, ICI Letter; Putnam Letter; Morgan Stanley Letter; Letter from Eric R. Dinallo, Executive Vice President, General Counsel, Guardian Life (Aug. 7, 2018) ("Guardian August 2018 Letter") (cautioning against inclusion of "costs" into rule text or overemphasizing its importance).

560 *See, e.g.*, AFL-CIO April 2019 Letter (stating "If, as has been suggested, one goal is to ensure that brokers give greater consideration to costs in determining what investments to recommend, [Regulation Best Interest] should incorporate an explicit requirement to consider costs in the rule text."); NASAA August 2018 Letter; U. of Miami Letter (supporting addition of "costs" into rule text). *See also* CFA August 2018 Letter (supporting the Commission's emphasis of cost and associated financial incentives as more important factors, and stating "[t]his requirement would be clearer, however, if it were incorporated into the rule text, which requires the broker to consider the 'potential risks and rewards associated with the recommendation,' rather than the material characteristics, including costs, of the recommended investment or investment strategy.").

561 *See* Relationship Summary Adopting Release.

upon the particular product or strategy recommended, cost—along with potential risks and rewards—will always be a relevant factor that will bear on the return of the security or investment strategy involving securities.[562] This would include, for example, both costs associated with the purchase of the security, as well as any costs that may apply to the future sale or exchange of the security, such as deferred sales charges or liquidation costs. Elevating cost to the rule text clarifies that this factor must *always* be considered when making a recommendation. Thus, a broker-dealer, in fulfilling its obligation to make a recommendation in the best interest of its retail customer, must exercise reasonable diligence, care, and skill to understand the "potential risks, rewards, *and costs*" associated with the recommendation and have a reasonable basis to believe that the recommendation is in the best interest of the retail customer based on these factors.

Importantly, however, while cost, like potential risks and rewards, is always a factor that a broker-dealer must consider in making a recommendation, it is not a dispositive factor and its inclusion in the rule text is not meant to limit or foreclose the recommendation of a more costly or complex product that a broker-dealer has a reasonable basis to believe is in the best interest of a particular retail customer.[563] Moreover, we are reiterating that the standard does not

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562 *See* Vanguard Letter ("We agree that costs and remuneration should play a central role in meeting the revise best interest standards. Cost is a critical factor because of its compounding effect upon performance.").

563 *See* Proposing Release at 21587-21589; 21610-21612.

necessarily require the lowest cost option, and that while cost is an important factor that always needs to be taken into consideration in making a recommendation, it is not the only one.[564] Rather, as explained more fully below, the evaluation of cost would be more analogous to a broker-dealer's best execution analysis, which does not require the lowest possible cost, but rather looks at whether the transaction represents the best qualitative execution for the customer using cost as one factor.[565]

Several commenters expressed concern over the emphasis of "cost" and suggested that, for example, more emphasis be placed on additional or subjective factors beyond specific product attributes.[566] Those commenters stated that the emphasis on cost may discourage certain products or investment strategies. Our intent is not to discourage or otherwise limit the

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564 *See* Proposing Release at 21610.

565 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 (Jun. 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; *see also* Proposing Release at 21615. Certain commenters pointed to best execution analysis as an example of a rule or guidance that is facts-and-circumstances-based. *See, e.g.*, CFA August 2018 Letter ("Just as compliance with the best execution standard will not always be met by sending trades to the exchange where the lowest cost is displayed, compliance with a best interest standard will not always be satisfied by recommending the lowest cost option.").

566 *See, e.g.*, ICI Letter; BlackRock Letter; Putnam Letter; Transamerica August 2018 Letter; Northwestern Mutual Letter; *see also* Vanguard Letter (recognizing the importance of cost, but urging the Commission to maintain a principles-based approach recognizing the importance of "holistic advice that necessarily contemplates factors beyond cost.").

recommendation of products or investment strategies where a broker-dealer concludes that the recommendation is in the best interest of the retail customer. Instead, we believe that cost will always be relevant to a recommendation and accordingly should be a required consideration as set forth in the rule text. It should never be the only consideration. Additional factors such as those cited by commenters also should be taken into consideration as the broker-dealer formulates a recommendation consistent with the best-interest standard.[567]

Though we are declining to expressly define "best interest" in the rule text, as discussed above,[568] we are providing guidance regarding the application of the Care Obligation and in particular what it means to make a recommendation in the retail customer's "best interest." In addition, to emphasize the importance of determining that each recommendation is in the best interest of the retail customer and that it does not place the broker-dealer's interests ahead of the retail customer's interests, we are expressly incorporating into the rule text of Paragraph (a)(2)(ii)(B) and Paragraph (a)(2)(ii)(C) of Regulation Best Interest that a broker-dealer must

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567 *See, e.g.,* BlackRock Letter (citing consideration of investors' needs and desired outcomes relative to service offerings of several different managers); Vanguard Letter ("considerations include important factors such as product structure, investment features, liquidity, volatility, issuer reputation, brand and business practices (securities lending activities, portfolio tracking error, or usage of derivatives in a portfolio)"); ICI Letter (citing several subjective factors, such as the "nature and quality of a provider's services (including advantages to the investor of consolidating investments as a single firm, such as higher levels of service that may be offered), minimum initial investments, and firm reputation"); FIBA February 2019 Letter (citing "highly personalized non-economic reasons underlying cross-border investment").

568 *See* Section II.A.2.

have a reasonable basis to believe that the recommendation "does not place the financial or other interest of the [broker-dealer]… ahead of the interest of the retail customer." While we acknowledge that a broker-dealer and an associated person can and will have some financial interest in a recommendation, as noted above, this addition to the Care Obligation makes clear these interests cannot be placed ahead of the retail customer's interests when making a recommendation.[569]

Finally, we believe that by explicitly requiring in the rule text that the broker-dealer have a reasonable basis to believe that a recommendation is both in the retail customer's "best interest" and does "not place the financial or other interest" of the broker-dealer ahead of the retail customer's interests, we are enhancing the Care Obligation by imposing obligations beyond existing suitability obligations. Under existing suitability requirements, a broker-dealer is required to make recommendations that are "suitable" for the customer. While certain cases and guidance have interpreted FINRA's suitability rule to require that "a broker's recommendations must be *consistent with his customers' best interests,*" and FINRA has further interpreted the requirement to be "consistent with the customer's best interest" to prohibit a broker-dealer from placing his or her interests ahead of the customer's interests, this obligation is not explicitly

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[569] *See id*. *See also* AFL-CIO April 2019 Letter (noting "Adopting a standard that explicitly states that brokers are prohibited form placing their own interests ahead of the retail customer's interests reinforces [investors' reasonable expectations that the financial professionals they rely on for investment advice will put their interests first]" and asserting that "a requirement to place the customer's interests ahead of the brokers' interests must be included in the operational provisions of Reg BI….").

required by FINRA's rule (or its supplementary material), nor does the interpretation require recommendations to be *in the* best interest (as opposed to "*consistent with* the best interest") of a retail customer.[570] We believe that requiring recommendations to be in the best interest is declarative of what must be done, and therefore stronger than, requiring recommendations to be "consistent with" the best interest of the retail customer, which we believe at a minimum creates ambiguity as to whether the recommendation must be in the retail customer's best interest or something less.[571]

The Care Obligation significantly enhances the investor protection provided as compared to current suitability obligations by: (1) explicitly requiring in Regulation Best Interest that recommendations be in the best interest of the retail customer and do not place the broker-dealer's interests ahead of the retail customer's interests; (2) explicitly requiring by rule the

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570 *See* FINRA Regulatory Notice 12-25 at Q1. *See also* FINRA Letter to Senators Warren, Brown, and Booker (Aug. 3, 2018) ("FINRA 2018 Letter") (stating that "[w]hile FINRA's suitability rule implicitly requires a broker-dealer's recommendations to be consistent with customer's best interests, the SEC's proposed best interest standard explicitly establishes the customer's best interest as an overarching standard of care for broker-dealers." (internal citations omitted)). Some commenters have also made this point. *See, e.g.,* CFA August 2018 Letter ("In enforcing that standard, however, FINRA has only rarely and very narrowly enforced the obligation to do what is best for the customer—typically in cases that involve recommending the most appropriate share class of a particular mutual fund. . . . Indeed, as we detailed in our July 2015 comment letter to the Department of Labor, most of the cases in which FINRA and the Commission have asserted an obligation for brokers to act in customers' best interest have involved egregious frauds rather than questions of whether customers' best interests were being served.").

571 *See, e.g.*, CFA August 2018 Letter.

consideration of costs when making a recommendation; and (3) applying the obligations relating to a series of recommended transactions (currently referred to as "quantitative suitability") irrespective of whether a broker-dealer exercises actual or *de facto* control over a customer's account.[572] In addition, it is our view that a broker-dealer should consider "reasonably available alternatives" as part of having a "reasonable basis to believe" that the recommendation is in the best interest of the retail customer, which we also believe is an enhancement beyond existing suitability expectations.[573]

a. *Exercise Reasonable Diligence, Care, and Skill*

A broker-dealer is required to "exercise reasonable diligence, care, and skill" to satisfy the three components of the Care Obligation set forth in Regulation Best Interest. In the

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572 *See* FINRA 2018 Letter (noting that proposed Regulation Best Interest augments and enhances current requirements by, among other things: "explicitly impos[ing] a 'best interest' standard, making clear that a broker-dealer cannot put its interests ahead of the interests of its customers. While FINRA's suitability rule implicitly requires a broker-dealer's recommendations to be consistent with customers' best interests, the SEC's proposed best interest standard explicitly establishes the customer's best interest as an overarching standard of care for broker-dealers;" "explicitly requir[ing] broker-dealers to consider 'reasonably available alternatives' to a recommended security and justify any choice of a more costly product. … Although case law and FINRA guidance establish cost and available alternatives as factors to consider as part of a FINRA suitability assessment, particularly regarding mutual fund share classes, proposed Reg Bl expressly establishes the significance of these factors"; and "remov[ing] the 'control' element for purposes of quantitative suitability, which would make this obligation more enforceable.") (internal citations omitted).

573 *See infra* Section II.C.2.c, Application of the Care Obligation – Reasonably Available Alternatives and Otherwise Identical Securities.

Proposing Release, we included "prudence," and explained that "prudence" "conveys the fundamental importance of conducting a proper evaluation of any securities or investment strategy recommendation in accordance with an objective standard of care."[574] Further, we solicited comment on all aspects of the Care Obligation, and also asked specifically whether there was adequate clarity and understanding regarding the term "prudence," or whether other terms were more appropriate in the context of broker-dealer regulation.

Several commenters supported adopting a principles-based obligation, thus requiring the broker-dealer to assess the adequacy of a recommendation based on the facts and circumstances of each recommendation.[575] We also received numerous comments asking for further guidance relating to recommendations of specific securities or asking how the Care Obligation applies to certain factual scenarios.[576] With respect to the term "prudence," a number of comments requested removal of the term, stating that such language is unnecessary given the other requirements to satisfy the Care Obligation, as well as the fact that the term introduces legal confusion and uncertainty.[577] Other commenters supported the use of the term "prudence"

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574 Proposing Release at 21609.

575 *See, e.g.,* SIFMA August 2018 Letter; Vanguard Letter; Morningstar Letter; Edward Jones Letter.

576 *See, e.g.,* SIFMA August 2018 Letter; Direxion Letter; Chapman Letter.

577 *See, e.g.*, Primerica Letter (stating "….the term [prudence] raises numerous interpretative issues and compliance risks. Regulatory and judicial interpretations of ERISA 'prudence' and its requirements abound, but these are exclusive to employee benefit plan duties and do not address duties with respect to retail accounts for individual

because they believed that Regulation Best Interest's component obligations generally rested on a "prudence" standard or maintained that the Care Obligation "echoes elements found in the common law 'prudent person rule,'" and thus thought its addition was appropriate to capture, or describe, these obligations.[578]

After careful consideration of comments, we are revising the Care Obligation to remove the term "prudence." Accordingly, the Care Obligation will require broker-dealers to "exercise reasonable diligence, care, and skill" to meet the three components of the Care Obligation. We

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customers."); Transamerica August 2018 Letter ("The term 'prudence' is one used primarily in the ERISA context and is not generally used in the federal securities laws. We believe inclusion of the term 'prudence' in describing the care obligation is unnecessary and could lead to confusion in interpretation of the care obligation set forth in the Proposal"); IPA Letter ("'Prudence' is an ERISA term based on trust law that is not generally used under the federal securities laws"). *See also* Fein Letter (discussing that the "duties of loyalty and care are the core fiduciary standards that apply across all fiduciary fields, including trust law, agency law, and employee benefits law;" that "[b]oth of these duties are reflected in the existing regulation of broker-dealers and investment advisers when they give investment advice to retail customers;" and that the "duty of care—also called 'prudence'—requires a fiduciary to act with care, skill and diligence in fulfilling his designated functions.") (internal citations omitted).

578 *See* LPL August 2018 Letter ("We believe that each of the four component obligations identified in Regulation BI generally rests on a 'prudence' standard that is the foundation of the common law principles and the Federal law that have governed the activities of financial services providers for decades. The obligation to provide prudent recommendations that are appropriate for an investor's circumstances is a principal component of the suitability obligations that apply to investment advisers under the [Advisers Act]" (internal citations omitted); FPC Letter (stating that "the duty of care, as described by both Reg BI and CFP Board Standards, echoes elements found in the common law 'prudent person rule' which can serve to measure the reasonableness of a prudent professional's actions…."); *see also* CFA August 2018 Letter; NAIFA Letter.

are persuaded by commenters that its inclusion in the proposed rule text to satisfy the components of the Care Obligation is superfluous and unnecessarily presents the possibility for confusion and legal uncertainty.[579] We believe requiring broker-dealers "to exercise reasonable diligence, care, and skill" conveys "the fundamental importance of conducting a proper evaluation of any securities recommendation in accordance with an objective standard of care"[580] that was intended by the inclusion of "prudence." Removing "prudence" does not lessen nor otherwise change the requirements or our expectations under the Care Obligation, or Regulation Best Interest more broadly as it was duplicative of the phrase "diligence, care, and skill."[581] The revised obligation, in requiring the broker-dealer to "exercise[] reasonable diligence, care and skill" and to have a "reasonable basis to believe that the recommendation is in the best interest…and does not place" the interest of the broker-dealer ahead of the interest of the retail customer, will continue to require an analysis that is comparable to the notion of "prudence" as described in other regulatory frameworks,[582] but does so using the terms "diligence, skill, and

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579 *See supra* footnote 577.

580 Proposing Release at 21609.

581 *See, e.g.,* LPL August 2018 Letter (noting that the component obligations of Regulation Best Interest generally rest on "prudence" concepts); Fein Letter.

582 *See* Fein Letter (stating that the "duty of care—also called 'prudence'—requires a fiduciary to act with care, skill and diligence in fulfilling his designated functions") (citing Restatement 3d of Agency, § 8.08 Duties of Care, Competence, and Diligence ("[s]ubject to any agreement with the principal, an agent has a duty to the principal to act with care, competence, and diligence normally exercised by agents in similar circumstances….")). The DOL interpreted "prudence" to represent "an objective standard

care"—terminology with which broker-dealers are familiar and that is well understood under the federal securities laws.[583] As such, we believe that the revised language will minimize the potential confusion and legal uncertainty created by using a term that is predominantly interpreted in other legal regimes,[584] and will aid broker-dealers in achieving compliance with Regulation Best Interest as well as permit broker-dealers to utilize existing compliance and supervisory systems that already rely on this language.

Moreover, we note that certain commenters' support for the term "prudence" was based on our interpretation of the Care Obligation in the Proposing Release.[585] As noted above, the removal of the term "prudence" does not change the obligations or our interpretation of the Care Obligation, which we believe are addressed by the "diligence, care, and skill" language and through Regulation Best Interest more broadly. In light of concerns regarding legal uncertainty associated with the term "prudence," and our view that its inclusion or removal would not

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of care that requires investment advice fiduciaries to investigate and evaluate investments, make recommendations, and exercise sound judgment in the same way that knowledgeable and impartial professionals would." BIC Exemption Release, 81 FR 21208 at 21028-21029.

583 *See, e.g.,* Proposing Release at 21595, 21609-21613. The discussion that follows addresses what it means to "exercise reasonable diligence, care, and skill" in the context of each aspect of the Care Obligation.

584 *See supra* footnote 577.

585 *See, e.g.*, NAIFA Letter.

change the requirements or expectations of Regulation Best Interest, we have determined to remove it from the rule text.

Finally, in response to comments, we are retaining the facts-and-circumstances determination for the reasons set forth in the Proposing Release,[586] and providing additional guidance on the application of the components of the Care Obligation with respect to certain securities and under certain scenarios. As we noted in the Proposing Release, such an approach is consistent with how broker-dealers are currently regulated with respect to the suitability of their recommendations and would allow broker-dealers to utilize and incorporate pre-existing compliance systems. In addition, this approach is generally consistent with the principles-based approach applicable to the duty of care of investment advisers.[587]

b. Understand potential risks, rewards, and costs associated with recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers.

Under the proposed "reasonable basis" component of the Care Obligation, broker-dealers would be required to understand the potential risks and rewards of the recommendation and have a reasonable basis to believe that the recommendation could be in the best interest of at least

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586 Proposing Release at 21587 ("[W]e 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.").

587 *See* Fiduciary Interpretation.

some retail customers. Although potential costs were not specifically included in the proposed rule text as a factor to be considered as part of a recommendation, the Proposing Release identified potential costs associated with a recommendation as an important factor to understand and consider as part of making a recommendation, and likewise as a key factor to consider when evaluating whether or not a broker-dealer had a reasonable basis to believe it was acting in the best interest of the retail customer when making the recommendation.[588]

After careful consideration of comments, the Commission is adopting, for the reasons set forth in the Proposing Release, Paragraph (a)(2)(ii)(A) of the Care Obligation substantially as proposed. However, as discussed above, in addition to requiring broker-dealers to understand the potential risks and rewards associated with the recommendation, we are also expressly requiring them to understand and consider the *potential costs* associated with a recommendation. Elevating costs to the rule text is consistent with a number of commenters' recommendations and, importantly, stresses that cost will always be a salient factor to be considered when making a recommendation.[589] Additionally, this requirement that the broker-dealer understands and considers costs is a distinct enhancement over existing reasonable basis suitability obligations, which do not expressly require this consideration.[590] Nevertheless, we recognize—and emphasize—that cost is one important factor among many factors, and thus provide additional

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588 *See* Proposing Release at 21609-21612. *See also supra* footnote 572.

589 *See, e.g.,* AFL-CIO April 2019 Letter; NASAA August 2018 Letter; U. of Miami Letter.

590 *See supra* footnote 572.

guidance below regarding the importance of weighing and considering costs in light of other relevant factors and the retail customer's investment profile.

Paragraph (a)(2)(ii)(A) of Regulation Best Interest is intended to incorporate and build upon broker-dealer's existing "reasonable-basis suitability" obligations and would relate to the broker-dealer's understanding of the particular security or investment strategy recommended, rather than to any particular retail customer. Without establishing such a threshold understanding of its particular recommended security or investment strategy involving securities, we do not believe that a broker-dealer could, as required by Regulation Best Interest, have a reasonable basis to believe that it is acting in the best interest of a retail customer when making a recommendation.[591]

In order to meet the requirement under Paragraph (a)(2)(ii)(A), a broker-dealer would need to undertake reasonable diligence, care, and skill to understand the nature of the recommended security or investment strategy involving a security or securities, as well as the potential risks, rewards—and now costs—of the recommended security or investment strategy, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers based on that understanding. A broker-dealer must adhere to both components of Paragraph (a)(2)(ii)(A). For example, a broker-dealer could violate the obligation by not understanding the potential risks, rewards, or costs of the recommended security or

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591 *See* Proposing Release at 21609-21610 (for further discussion regarding this requirement).

investment strategy, even if the security or investment strategy could have been in the best interest of at least some retail customers. Conversely, even if a broker-dealer understands the recommended security or investment strategy, the broker-dealer 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.

What would constitute reasonable diligence, care, and skill under Paragraph (a)(2)(ii)(A) will vary depending on, among other things, the 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.[592] While every inquiry will be specific to the particular broker-dealer and the recommended security or investment strategy, broker-dealers generally should consider important factors such as the security's or investment strategy's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety 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. Together, this inquiry should allow the broker-dealer to develop a sufficient understanding of the security or investment strategy and to be able to reasonably believe that it could be in the best interest of at least some retail customers.

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[592] *See* FINRA Rule 2111.05(a).

This "reasonable-basis" component of the Care Obligation is especially important when broker-dealers recommend securities and investment strategies that are complex or risky.[593] For example, in recent years, the Commission staff and FINRA have addressed broker-dealer sales practice obligations under existing law relating to complex products, such as inverse or leveraged exchange-traded products.[594] These products, which may be useful for some sophisticated trading strategies, are highly complex financial instruments and are typically designed to achieve their stated objectives on a daily basis.[595] However, because of the effects of compounding, the performance of these products over longer periods of time can differ significantly from their

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593 *See* FINRA Rule 2111 (Suitability) FAQ at Q5.1 ("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.). *See also SEC v. Hallas*, No. 17-cv-02999 (S.D.N.Y. filed Apr. 25, 2017).

594 *See* FINRA Regulatory Notice 09-31, Non-Traditional ETFs – FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds (June 2009); SEC staff and FINRA, Investor Alert, Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors (Aug. 1, 2009); SEC Office of Investor Education and Advocacy, Investor Bulletin: Exchange-Traded Funds (ETFs) (Aug. 2012).

595 *See id. See also* Exchange-Traded Funds, Securities Act Release No. 10515 (Jun. 28, 2018); Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015) [80 FR 80883 (Dec. 28, 2015)] ("Derivatives Proposing Release"); Direxion Letter (recognizing that leveraged ETFs are not appropriate for all customers, and thus the importance for broker-dealers to perform sufficient diligence to adequately "understand the terms and features of such funds, including how they are designed to perform, how they achieve that objective, and the impact that market volatility, the ETF's use of leverage, and the customer's intended holding period will have on their performance").

stated daily objectives. Thus, broker-dealers recommending such products should understand that inverse and leveraged exchange-traded products that are reset daily may not be suitable for, and as a consequence also not in the best interest of, retail customers who plan to hold them for longer than one trading session, particularly in volatile markets.[596] Without understanding the terms, features, and risks of inverse and leveraged exchange-traded products—as with the potential risks, rewards, and costs of any security or investment strategy—a broker-dealer could not establish a reasonable basis to recommend these products to retail customers.[597] Further, these products may not be in the best interest of a retail customer absent an identified, short-term, customer-specific trading objective. Similarly, when a broker-dealer recommends a potentially high risk product to a retail customer—such as penny stocks or other thinly-traded securities—the broker-dealer should generally apply heightened scrutiny to whether such investments are in a retail customer's best interest.[598]

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596 *See supra* footnotes 593 - 595.

597 *See id*.

598 *See, e.g.*, FINRA Regulatory Notice 17-32, Volatility-Linked Exchange Traded Products – FINRA Reminds Firms of Sales Practice Obligations for Volatility-Linked Exchange-Traded Products (Oct. 2017) (explaining that "The level of reasonable diligence that is required will rise with the complexity and risks associated with the security or strategy. With regard to a complex product such as a volatility-linked ETP, an associated person should be capable of explaining, at a minimum, the product's main features and associated risks."); FINRA Regulatory Notice 12-03, Complex Products – Heightened Supervision of Complex Products (Jan. 2012) (stating that "Reasonable diligence must provide the firm or registered representative 'with an understanding of the potential risks and rewards associated with the recommended security or strategy.' This understanding

Finally, several commenters expressed concern about the applicability of Regulation Best Interest to variable annuities and variable life insurance products.[599] Variable annuities and variable life insurance products have generated special attention from regulators and their staff, such as statements regarding sales practice obligations and specific FINRA rules relating to the recommendation of variable annuities.[600] These variable insurance products are often unique and have different features depending on the company providing the product, as well as depending on the chosen investment options, benefits, fees and expenses, liquidity restrictions, and other considerations.[601] Consistent with existing FINRA rules and existing suitability obligations under the federal securities laws and SRO rules, regulators and their staffs have stated that recommendations of these products would require careful attention and a specific

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should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions. The lack of such an understanding when making the recommendation could violate the suitability rule.") (internal citations omitted).

599 *See* related discussion in Section II.C.2.c, Retail Customer Investment Profile.

600 *See, e.g.,* FINRA Rule 2330, Members Responsibilities Regarding Deferred Variable Annuities; FINRA Rule 2320, Variable Contracts of Insurance Companies; FINRA Regulatory Notice 10-05, Deferred Variable Annuities – FINRA Reminds Firms of Their Responsibilities Under FINRA Rule 2330 for Recommended Purchases or Exchange of Deferred Variable Annuities (Jan. 2010); SEC Updated Investor Bulletin: Variable Annuities (Oct. 30, 2018); SEC Investor Bulletin: Variable Life Insurance (Oct. 30, 2018).

601 *See id. See also* Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts, Investment Advisers Act Release No. 10569 (Oct. 30, 2018) [83 FR 61730 (Nov. 30, 2018)] ("VA Summary Prospectus Proposal").

understanding of certain factors, such as whether the product provides tax-deferred growth, or a death or living benefit, before a broker-dealer could establish an understanding of the product, and apply that understanding to a retail customer's investment profile in making a recommendation.

While we stress the importance of understanding the potential risks, rewards, and costs associated with a recommended security or investment strategy, as well as other factors depending on the facts and circumstances of each recommendation, we do not intend to limit or foreclose broker-dealers from recommending complex or more costly products or investment strategies where the broker-dealer has a reasonable basis to believe that a recommendation could be in the best interest of at least some retail customers and the broker-dealer has developed a proper understanding of the recommended product or investment strategy. As discussed below, once a broker-dealer develops an appropriate understanding of a securities product or investment strategy, including its potential costs, and believes it could be in the best interest of at least some retail customers, the broker-dealer will then need to apply that understanding to reasonably determine that the recommended product or investment strategy is in the particular retail customer's best interest at the time of the recommendation.

c. Have a Reasonable Basis to Believe 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 Interest of the Broker-Dealer Ahead of the Interest of the Retail Customer

In the Proposing Release, we stated that beyond establishing an understanding of the recommended securities transaction or investment strategy, in order to act in the best interest of the retail customer, a broker-dealer would be required 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 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)(A), the second sub-component of the Care 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." In the Proposing Release, the Commission further articulated that 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. This was intended to incorporate a broker-dealer's existing well-established obligations under "customer-specific suitability," but also to enhance 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.

Commenters largely supported the Commission's proposed approach, but several commenters requested clarifying guidance regarding the importance of costs and other specific factors in a "best interest" evaluation, as well as more broadly how "best interest" was to be determined.[602] For example, several commenters requested additional guidance on the role of costs and other "relevant factors," including subjective and qualitative factors such as

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602 *See, e.g.*, Wells Fargo Letter; Primerica Letter; Great-West Letter; NASAA August 2018 Letter; Cambridge Letter; BlackRock Letter.

shareholder support services, redemption procedures, or qualifications of the investment adviser.[603] Similarly, several commenters asked for clarification that "best interest" does not necessarily mean the lowest cost option or require the broker-dealer to look at every single possible security.[604] Commenters also requested further direction regarding guidance in the Proposing Release related to the consideration of "reasonably available alternatives" and "otherwise identical securities," and requested certain modifications to the definition of "Retail Customer Investment Profile."[605]

After careful consideration of these comments, for the reasons set forth in the Proposing Release, the Commission is adopting the "customer specific" component of the Care Obligation substantially as set forth in the Proposing Release. However, as included under the reasonable basis component of the Care Obligation and for the reasons discussed above, the Commission is expressly incorporating "costs" into the rule text to emphasize that broker-dealers must consider the potential costs associated with a recommendation to a particular retail customer.

As noted above, the Commission is also incorporating into the rule text that broker-dealers must have a reasonable basis to believe that the recommendation "does not place the

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603 *See* Chapman Letter; BlackRock Letter; Vanguard Letter; ICI Letter; Morgan Stanley Letter.

604 *See* Great-West Letter; SIFMA August 2018 Letter.

605 *See, e.g.*, Committee of Annuity Insurers Letter; Guardian August 2018 Letter; IPA Letter; Morgan Stanley Letter; Invesco Letter; CFA August 2018 Letter.

financial or other interest of the broker-dealer ahead of the interest of the retail customer."[606] This addition is intended to make clear that while a broker-dealer typically will have some interest in a recommendation, the broker-dealer cannot put that interest ahead of the retail customer's interest when making the recommendation.

To address feedback from commenters, the Commission is also providing further interpretations and guidance regarding the application of the Care Obligation, and in particular, what it means to make a recommendation in a retail customer's best interest and not place the broker-dealer's interest ahead of the retail customer's interest. Specifically, recognizing that a facts and circumstances evaluation of a recommendation makes it difficult to draw bright lines around whether a particular recommendation would meet the Care Obligation, the Commission is providing further interpretations and guidance on how a broker-dealer could have a "reasonable basis to believe" that a recommendation is in the best interest of its retail customer and does not place the broker-dealer's interest ahead of the retail customer's interest, as well as circumstances when we believe that a broker-dealer could not have such a reasonable belief.

Factors to Consider Regarding a Recommendation to a Particular Retail Customer and Relevance of Cost

Consistent with paragraph (a)(2)(ii)(A) of the Care Obligation, we are incorporating "costs" in the rule text of paragraph (a)(2)(ii)(B) of Regulation Best Interest as a relevant factor that, in addition to risks and rewards, must always be understood and considered by the broker-

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606 *See* related discussion in Section II.A.2; *see also* Fiduciary Interpretation.

dealer prior to recommending a particular securities transaction or investment strategy involving securities to a particular retail customer. As discussed above, under paragraph (a)(2)(ii)(A) of the Care Obligation, a broker-dealer will be required to exercise reasonable diligence, care, and skill to understand the potential risks, rewards, and costs of a recommended security or investment strategy and have a reasonable basis to believe that it *could be* in the best interest of *at least some* retail customers.[607] Paragraph (a)(2)(ii)(B) of the Care Obligation builds on this obligation and will require a broker-dealer to have a reasonable basis to believe, based on its understanding of the potential risks, rewards, and costs of the recommendation, and in light of the retail customer's investment profile, that the recommendation is in the best interest of a *particular* retail customer and does not place the broker-dealer's interest ahead of the retail customer's interest. Accordingly, when making a recommendation to a particular retail customer, broker-dealers must weigh the potential risks, rewards, and costs of a particular security or investment strategy, in light of the particular retail customer's investment profile. As discussed above,[608] a broker-dealer's diligence, care, and skill to understand the potential risks, rewards, and costs of a security or investment strategy should generally involve a consideration of factors, depending on the facts and circumstances of the particular recommendation and the particular retail customer's investment profile, as discussed below.

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607 *See* Proposing Release at 21610-21611.

608 *See* related discussion in Section II.C.2.a and Section II.C.2.b.

While the factors noted above are examples of important factors to consider based on the particular security or investment strategy, this list is not exhaustive and additional factors, including those raised by commenters, could be relevant depending on the particular security or investment strategy being recommended and depending on the particular retail customer's investment profile. For example, prior to recommending a variable annuity to a particular retail customer, broker-dealers should generally develop a reasonable basis to believe that the retail customer will benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit.[609]

As stated in the Proposing Release, the importance of each factor in determining the customer-specific component of the Care Obligation will depend on the facts and circumstances of each recommendation. Thus, 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 for determining that the factors are not relevant. Regardless of which factors are evaluated—and equally important, which factors are not evaluated—a broker-dealer must have a reasonable basis to believe that the particular recommendation is in the best interest of the particular retail customer and does not place the broker-dealer's interest ahead of the retail customer's interest, consistent with the interpretations and guidance provided. For example, recommendations of the "lowest cost" security or investment strategy, without consideration of other factors, could violate

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609 *Cf. also* FINRA Rule 2330, Members' Responsibilities Regarding Deferred Variable Annuities. *See* Transamerica November 2018 Letter.

Regulation Best Interest. In the same vein, it is important to consider that a recommendation may be considered to be in a retail customer's best interest when viewed in the context of the retail customer's portfolio even if seemingly not in a retail customer's best interest when viewed in isolation (e.g., inclusion of what otherwise might be seen as a risky investment in the portfolio of a risk-adverse customer, such as including hedging instruments in a conservative portfolio).

The customer-specific component of the Care Obligation will rest on whether a broker-dealer had a reasonable basis to believe that the recommendation was in the best interest of the particular retail customer at the time of the recommendation, based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation, and did not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer. Thus, as discussed further below, the importance of each factor, and which factors to consider, will depend on the facts and circumstances of each recommendation, as well as the specific security or investment strategy.

While the Care Obligation does not require broker-dealers to document the basis for a recommendation, broker-dealers may choose to take a risk based approach when deciding whether or not to document certain recommendations. For example, broker-dealers may wish to document an evaluation of a recommendation and the basis for the particular recommendation in certain contexts, such as the recommendation of a complex product, or where a recommendation

may seem inconsistent with a retail customer's investment objectives on its face.[610] Similarly, broker-dealers may consider using existing compliance measures, such as generating and reviewing exception reports that identify transactions that fall outside of firm-specified parameters to help evaluate and review for compliance with the Care Obligation. These measures are not meant to be exhaustive, but rather are examples of the sorts of compliance tools and methods broker-dealers should generally consider using in evaluating whether recommendations are consistent with a retail customer's best interests.

Retail Customer Investment Profile

The Proposing Release would have required a "Retail Customer Investment Profile" to include, but not be 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."[611] The Proposing Release also explained that broker-dealers would be

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610 *See* FINRA Regulatory Notice 11-25 at FAQ 2 (explaining that FINRA Rule 2111 (Suitability) permits firms to take a risk-based approach with respect to documenting suitability determinations). Regulation Best Interest similarly does not require documentation; however, as noted above, we encourage broker-dealers to take a risk-based approach when deciding whether or not to document certain recommendations.

611 Proposing Release at 21611 (noting the proposed definition of Retail Customer Investment Profile was consistent with FINRA Rule 2111(a) (Suitability), which provides that "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,

required to exercise "reasonable diligence" to ascertain the retail customer's investment profile as part of satisfying proposed paragraph (a)(2)(i)(B), and that when retail customer information is unavailable despite a broker-dealer's reasonable diligence to obtain such information, a broker-dealer should consider whether it has sufficient understanding of the retail customer to properly evaluate whether the recommendation is in the retail customer's best interest.[612] Furthermore, under the proposed rule, a broker-dealer would not meet its Care Obligation if it made 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 such customer's investment profile.

In response to this definition and the related discussion, commenters identified several additional factors that they believed should be included or discussed as part of a retail customer's investment profile. For example, several commenters suggested adding "longevity risk," "retirement income needs," or "lifetime income needs" as factors that should be included as part

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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").

612 *Id.* This is similar to the approach articulated below, as well as in FINRA Regulatory Notice 12-25, which outlines what constitutes "reasonable diligence" under FINRA's suitability rule in attempting to obtain customer-specific information and that the reasonableness of the effort also will depend on the facts and circumstances. *See* FINRA Regulatory Notice 12-25 at Q16. Moreover, under Regulation Best Interest, as with the approach under FINRA's suitability rule, broker-dealers may generally rely on a retail customer's responses absent "red flags" indicating that the information is inaccurate. *Id.*

of an investor's investment profile.[613] Other commenters suggested additional factors, such as, for trust accounts, considering the profile of trust beneficiaries and not the trustee, or adding a retail customer's "income profile."[614]

While we agree that many of these factors will likely be relevant to a broker-dealer's recommendation of various securities or investment strategies involving securities, we are adopting the definition of "retail customer investment profile" as proposed. We believe that the list of factors under "retail customer investment profile" is widely understood and importantly, offers broker-dealers the flexibility to consider additional factors as deemed necessary.[615] Although many of the additional factors cited by commenters may be relevant to securities or investment strategy recommendations under certain facts and circumstances, we are not persuaded that we should add any specific factor or factors to the existing list of profile factors, particularly given that the list of factors is non-exhaustive and broker-dealers can consider additional factors as appropriate under the unique facts and circumstances of each recommendation. Thus, for example, where a broker-dealer making a variable annuity

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613 *See, e.g.*, IRI Letter, The Committee of Annuity Insurers Letter, CCMC Letters, Jackson National Letter, Pacific Life August 2018 Letter, Lincoln Financial Letter, AXA Letter, Principal Letter; Transamerica November 2018 Letter; Letter from Mark F. Halloran, VP Managing Director, Business Development, Transamerica (Dec. 14, 2018) ("Transamerica December 2018 Letter").

614 *See, e.g.*, Jackson National Letter, Lincoln Financial Letter; Transamerica December 2018 Letter.

615 *See, e.g.*, CCMC Letters; Jackson National Letter; Pacific Life August 2018 Letter; Committee of Annuity Insurers Letter; AXA Letter.

recommendation believes that longevity risk is an important factor for a particular retail customer and that such factor is necessary to develop a reasonable basis to believe that the product is in the best interest of that retail customer, that broker-dealer should consider and utilize that factor.[616] We believe that this approach appropriately provides broker-dealers with a well-understood starting framework, but also gives broker-dealers the ability to consider additional factors based on the unique nature of its particular securities products, investment strategies, and retail customers.

Broker-dealers must obtain and analyze enough customer information to have a reasonable basis to believe that the recommendation is in the best interest of the particular retail customer. The significance of specific types of customer information generally will depend on the facts and circumstances of the particular case, including the nature and characteristics of the product or strategy at issue. Where retail customer information is unavailable despite a broker-dealer's reasonable diligence, the broker-dealer should carefully consider whether it has a sufficient understanding of the retail customer to properly evaluate whether the recommendation is in the best interest of that retail customer.[617] In addition, 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—that is, where a

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616 *See, e.g.*, AXA Letter; Committee of Annuity Insurers Letter; Pacific Life August 2018 Letter.

617 *See supra* footnotes 611-612 and accompanying text.

broker-dealer knows or has reason to believe that the customer's investment profile has changed.[618] The reasonableness of a broker-dealer's efforts 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.[619] Under Regulation Best Interest, as with the approach under FINRA's suitability rule, broker-dealers may generally rely on a retail customer's responses absent "red flags" indicating that the information is inaccurate.[620]

Moreover, as noted in the Proposing Release, 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 for determining that the factor is irrelevant to that particular best interest determination. However, consistent with existing obligations, where a broker-dealer determines not to obtain or analyze one or more of the factors specifically identified in the definition of "Retail Customer Investment Profile," the broker-dealer should document its determination that the factor(s) are not relevant components of a retail customer's investment profile in light of the facts and circumstances of the particular recommendation.[621]

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618 *See id.; see also* Proposing Release at 21611-21612.

619 *See id.; see also* FINRA Regulatory Notice 12-25 at Q16.

620 *See supra* footnote 612.

621 FINRA Rule 2111.04.

Regulation Best Interest, as noted above, does not require documentation of the basis for believing a particular recommendation was in a particular retail customer's best interest.[622] Nevertheless, broker-dealers may wish to consider documenting the basis for determining that the recommendation is in the best interest of the retail customer when it is not evident from the recommendation itself.[623] Documentation by itself will not cure a recommendation in circumstances in which a broker-dealer could not have reasonably believed the recommendation was in the best interest of the retail customer at the time the recommendation was made.[624]

Application of the Care Obligation—Reasonably Available Alternatives and Otherwise Identical Securities

In the Proposing Release, we provided guidance on what types of recommendations would or would not be in the best interest of a particular retail customer. In particular, the Proposing Release stated that where 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.[625] Similarly, in the Proposing Release, we

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622 As discussed in Section II.C.1, we believe that the basis for and risks associated with a broker-dealer's recommendations in standardized terms (as opposed to individualized disclosure of the basis for *each* recommendation made) is a material fact relating to the scope and terms of the relationship that is required to be disclosed under the Disclosure Obligation.

623 *See supra* footnote 610 and accompanying text.

624 *See* FINRA Rule 2111 (Suitability) FAQ.

625 Proposing Release at 21612.

noted our belief that it would be inconsistent with the Care Obligation if the broker-dealer made a recommendation to a retail customer in order to: maximize the broker-dealer's compensation, further the broker-dealer's business relationships, satisfy firm sales quotas or other targets, or win a firm-sponsored sales contest.[626]

We also stated that 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.[627] The Proposing Release explained that 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. Further, the Proposing Release indicated that under 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

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626 *Id.*

627 Proposing Release at 21608-21610.

market and economic conditions), in light of the retail customer's investment profile.[628] Relatedly, we stated that a broker-dealer could not meet the Care Obligation through disclosure alone.[629]

The Commission received numerous comments relating to the Proposing Release's discussion of "reasonably available alternatives" and regarding recommendations of "otherwise identical securities."[630] For example, commenters sought clarification regarding what factors need to be considered in the evaluation, and also how the evaluation could be performed in

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628 Proposing Release at 21612 (emphasis in original). We similarly noted that "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 [therein], 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." *Id.* (emphasis in original).

629 *Id.* at 21612-21613 (further explaining that "where a broker-dealer is choosing among identical securities with different cost structures, 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 Obligation, as the broker-dealer would not have complied with the Care Obligation. 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.") (internal citations omitted).

630 *See, e.g.,* Fidelity Letter; Vanguard Letter; MMI Letter; BlackRock Letter.

certain contexts, such as where a broker-dealer operates with an open architecture framework, recommends only a limited menu of products, or recommends only proprietary products.[631] A majority of the IAC recommended that Regulation Best Interest should be clarified to require recommendations of "the investments, investment strategies, accounts, or services, from among those that [the broker-dealers, investment advisers, and their associated persons] have reasonably available to recommend, that they reasonably believe represent the best available options for the investor" and that a "determination regarding the best reasonably available options should be based on a careful review of the investor's needs and goals, as well as the full range of the reasonably available products', strategies', accounts', or services' features, including, but by no means limited to cost."[632] Several other commenters recommended that the Commission confirm that Regulation Best Interest will not require broker-dealers to offer an unlimited number of securities or investment strategies.[633] Commenters also expressed concern over

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631 *See, e.g.,* CFA August 2018 Letter; Wells Fargo Letter; Fidelity Letter; Morgan Stanley Letter. *See also* LPL August 2018 Letter (suggesting that its representatives could not conduct a meaningful comparison across "all similar available securities" and that, such recommendations would be subject to legal challenges in hindsight).

632 IAC 2018 Recommendation (emphasis in original).

633 *See* LPL August 2018 Letter (recommending that the Commission clarify that a financial professional can satisfy his or her obligations under Regulation Best Interest, even if he or she limits recommendations to a smaller number of product sponsors because financial professionals participating on large platforms may, in practice, be discouraged from conducting focused analysis of product offerings, instead opting for a more cursory review of a few high-level cost, risk, and performance metrics across all available

whether the consideration of "reasonably available alternatives" would effectively require a broker-dealer to document the basis of any recommendation, as well as concerns about disclosure's role in satisfying the Care Obligation.[634] Finally, a majority of the IAC and other commenters sought clarification on whether broker-dealers were required to recommend only the single "best" product.[635]

The Care Obligation will require a broker-dealer to have a reasonable basis to believe, based on its understanding of the potential risks, rewards, and costs of the recommended security or investment strategy involving securities, and in light of the retail customer's investment profile, that the recommendation is in the best interest of a *particular* retail customer and does not place the broker-dealer's interest ahead of the retail customer's interest. As noted above, determining what is in a retail customer's best interest is an objective evaluation turning on the

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products). *See also* Fidelity Letter; Cetera August 2018 Letter; SIFMA August 2018 Letter; Guardian August 2018 Letter; Prudential Letter.

634 *See, e.g.*, Fidelity Letter; Wells Fargo Letter.

635 *See* 2018 IAC Recommendation ("The Commission should recognize that there will often not be a *single* best option and that more than one of the available options may satisfy this standard," and that "compliance should be measured based on whether the broker or adviser had a reasonable basis for the recommendation *at the time it was made,* and not on how the recommendation ultimately performed for the investor. . . ."); *see also* SIFMA August 2018 Letter.

facts and circumstances of the particular recommendation and the particular retail customer at the time the recommendation is made.[636]

Accordingly, as noted above, a broker-dealer would not satisfy the Care Obligation 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. A broker-dealer could recommend a more expensive security or investment strategy if there are other factors about the product that reasonably allow the broker-dealer to believe it is in the best interest of the retail customer, based on that retail customer's investment profile. Similarly, a broker-dealer could recommend a more remunerative security or investment strategy if the broker-dealer has a reasonable basis to believe that there are other factors about the security or investment strategy that make it in the best interest of the retail customer, in light of the retail customer's investment profile.

We also continue to have the view that, as part of determining whether a broker-dealer has a reasonable basis to believe that a recommendation is in the best interest of the retail customer, a broker-dealer generally should consider reasonably available alternatives offered by the broker-dealer. It is our view that such a consideration is an inherent aspect of making a "best interest" recommendation, and is a key enhancement over existing broker-dealer suitability

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636 As noted and further reiterated below, a broker-dealer will not be required to recommend the single "best" of all possible alternatives that might exist, in part because many different options may in fact be in the retail customer's best interest. *See infra* footnote 640 and accompanying text.

obligations, which do not necessarily require a comparative assessment among such alternatives.[637] Similarly, this concept has been applied in the context of guidance regarding suitability and heightened supervision of complex products, stating that when broker-dealers are recommending complex or costly products, they should first consider whether less complex or costly products could achieve the same objectives for their retail customers.[638]

In terms of conducting such an evaluation, a broker-dealer does not have to conduct an evaluation of every possible alternative, either offered outside of the firm (such as where the firm offers only proprietary or other limited range of products) or available on the firm's platform. We appreciate commenter concerns about the impracticality and potential impossibility of such a

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637 While enforcement actions and related guidance may be construed as interpreting the suitability obligation to include a consideration of available alternatives, it is generally limited to certain circumstances, such as recommendations of mutual funds with different share classes or recommendations of complex or costly products. *See In re Application of Raghavan Sathianathan*, Exchange Act Release No. 54722 at 21 (Nov. 8, 2006); *In the Matter of Wendell D. Belden*, 56 S.E.C. 496 (2003); FINRA Regulatory Notice 12-03. *See also* FINRA 2018 Letter; MSRB Rule G-42 (requiring a municipal advisor to inform its municipal entity or obligated person client whether it has investigated or considered other reasonably feasible alternatives to the recommended municipal securities transaction).

Thus, although certain enforcement actions and guidance contemplate a consideration of available alternatives under certain situations, it not a general expectation. Nevertheless, such statements serve as an example and evidence that the concept is not unfamiliar to broker-dealers.

638 *See* FINRA Regulatory Notice 12-03 ("For example, registered representatives should compare a structured product with embedded options to the same strategy through multiple financial instruments on the open market, even with any possible advantages of purchasing a single product."). *See also supra* footnote 635.

comparative evaluation, particularly where the firm offers numerous different products, many of which may have similar strategies but with other varying characteristics, including cost structures, that may apply differently based on the particular retail customer.[639] We also recognize that different products are rarely perfectly equal, and that differences will be both quantitative and qualitative in nature. A broker-dealer will not be required to recommend the single "best" of all possible alternatives that might exist, in part because many different options may in fact be in the retail customer's best interest.[640] We are sensitive to commenters' concern that this determination, to the extent it can be made at all, may be judged in hindsight even though Regulation Best Interest applies at the time of the recommendation.[641]

In particular, we are not requiring a natural person who is an associated person of the broker-dealer to be familiar with *every* product on a broker-dealer's platform, particularly where a broker-dealer operates in an open architecture framework or otherwise operates a platform with

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639 *See, e.g.,* Morgan Stanley Letter ("Large firms with an open architecture like Morgan Stanley offer an enormous range of products to their clients. To take but one example, Morgan Stanley offers approximately 300 large capitalization equity mutual funds to its retail customers."); *see also* Morningstar Letter; Primerica Letter; ICI Letter; Chapman Letter (stating that "identical" is too stringent because they believe all securities have distinctions).

640 Commenters suggesting different approaches acknowledged this concern. *See, e.g.,* IAC 2018 Recommendation ("[T]he Commission should recognize there will often not be a single best option and that more than one of the available options may satisfy this standard.").

641 *See* LPL August 2018 Letter.

a large number of products or options.[642] Such a requirement might not allow an associated person of a broker-dealer to develop a proper understanding of every security or investment strategy's potential risks, rewards, or costs, and thus it might not be possible to fulfill the obligation set forth in paragraph (a)(2)(ii)(A). Furthermore, such a requirement could encourage broker-dealers to limit their product menus or otherwise restrict access to products and services currently available to retail customers, which is contrary to the purpose and goals of Regulation Best Interest.[643]

As discussed above, the determination of whether a recommendation is in the "best interest" of the retail customer and does not place the interests of the broker-dealer ahead of the retail customer's interest must be based on information reasonably known to the associated person (based on her reasonable diligence, care, and skill) at the time the recommendation is made. Accordingly, in fulfilling the Care Obligation, the associated person should exercise reasonable diligence, care, and skill to consider reasonably available alternatives offered by the

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642 Conversely, where a broker-dealer only has a few products, an associated person of the broker-dealer may be expected to understand and consider all of these options when recommending a security or investment strategy. We recognize that this facts-and-circumstances approach does not provide a clear bright-line rule; however, we are providing further guidance below on a broker-dealer's process for evaluating reasonably available alternatives and the scope herein. Furthermore, nothing in this discussion excuses a broker-dealer from satisfying the Care Obligation. An associated person of the broker-dealer cannot use a large platform as an excuse for not developing a proper understanding of a recommended security or investment strategy's potential risks, rewards, or costs.

643 *See* LPL August 2018 Letter.

broker-dealer. This exercise would require the associated person to conduct a review of such reasonably available alternatives that is reasonable under the circumstances. Consistent with the Compliance Obligation discussed below, a broker-dealer should have a reasonable process for establishing and understanding the scope of such "reasonably available alternatives" that would be considered by particular associated persons or groups of associated persons (e.g., groups that specialize in particular product lines) in fulfilling the reasonable diligence, care, and skill requirements under the Care Obligation.

What will be a reasonable determination of the scope of alternatives considered will depend on the facts and circumstances, at the time of the recommendation, including both the nature of the retail customer and the retail customer's investment profile, and the particular associated persons or groups of associated persons that are providing the recommendations. With respect to broker-dealers that materially limit the range of products or services that they recommend to retail customers (e.g., limits its product offerings to only proprietary or other limited menus of products), the Conflict of Interest Obligation provision requires broker-dealers to have reasonably designed policies and procedures to identify and disclose the material limitations and any conflicts of interest associated with such limitations, and to prevent such limitations and associated conflicts of interest from causing the broker-dealer or associated person to make recommendations that place the interest of the broker-dealer or associated person

ahead of the interest of the retail customer.[644] Similarly, where a broker-dealer offers numerous products on its platform, a broker-dealer or an associated person could reasonably limit the universe of "reasonably available alternatives" if there is a reasonable process or methodology for limiting the scope of alternatives or the universe considered for a particular retail customer, particular category of retail customers, or the retail customer base more generally.[645]

In addition to the particular retail customer's investment profile, we believe the scope of reasonably available alternatives considered could depend upon a variety of factors, including but not limited to, the associated person's customer base (including the general investment objectives and needs of the customer base), the investments and services available to the associated person to recommend (including limitations due to licensing of the associated person), and other factors such as specific limitations on the available investments and services with respect to certain retail customers (e.g., product or service income thresholds; product geographic limitations; or product limitations based on account type, such as those only eligible

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644 *See* Section II.C.3. Broker-dealers would be required to disclose the conflict of interest, as well as the material facts associated with such a conflict pursuant to the Disclosure Obligation provision as described in Section II.C.1.

645 We note that where a broker-dealer (or an associated person) limits the securities or investment strategies that are considered as "reasonably available alternatives" from the universe of securities or investment strategies involving securities offered by the broker-dealer, this limitation may constitute a material limitation placed on the securities or investment strategies involving securities that may be recommended, which the broker-dealer (or an associated person) would need to disclose and address as provided in the Disclosure and Conflict of Interest Obligations.

for IRA accounts). A reasonable process would not need to consider every alternative that may exist (either outside the broker-dealer or on the broker-dealer's platform) or to consider a greater number of alternatives than is necessary in order for the associated person to exercise reasonable diligence, care, and skill in providing a recommendation that complies with the Care Obligation.

Importantly, where all reasonably available alternatives considered would be inconsistent with a retail customer's investment profile, a broker-dealer would not be able to form a reasonable belief that the best of these options is in the best interest of that retail customer. All recommendations to retail customers of securities or investment strategies are required to satisfy the Care Obligation, and broker-dealers cannot use a limited product menu or a process to determine the scope of reasonably available alternatives considered to justify a recommendation that is not in the best interest of the retail customer.

We recognize that the process by which a broker-dealer and its associated persons develop and make recommendations to retail customers, including the scope of reasonably available alternatives considered, will depend upon a variety factors, including the nature of the broker-dealer's business.[646] The disclosure of this process pursuant to the Disclosure Obligation

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646 Accordingly, we believe that disclosure of this process is of fundamental importance to a retail customer's understanding of what services are being provided, and in deciding whether those services are appropriate to the retail customer's needs and goals, and have thus clarified that the basis for a broker-dealer's or an associated person's recommendations as a general matter (i.e., what might commonly be described as the firm's or associated person's investment approach, philosophy or strategy) is a material

will provide critical information to retail customers and underscores our acknowledgment that we do not expect every broker-dealer or associated person to follow the same process. Instead, consistent with the Compliance Obligation, broker-dealers and their associated persons must have a reasonable process for developing and making recommendations to retail customers in compliance with the Care Obligation, including the consideration of reasonably available alternatives, which will depend on the facts and circumstances.

We emphasize that what is in the "best interest" of a retail customer depends on the facts and circumstances of a recommendation at the time it is made, including matching the recommended security or investment strategy to the retail customer's investment profile at the time of the recommendation, and the process for coming to that conclusion. Whether a broker-dealer has complied with the Care Obligation will be evaluated based on the facts and circumstances at the time of the recommendation (and not in hindsight) and will focus on whether the broker-dealer had a *reasonable basis to believe* that the recommendation is in best interest of the retail customer.

Finally, broker-dealers or their associated persons are not required to prepare and maintain documentation regarding the basis for each specific recommendation, including an evaluation of a recommended securities transaction or investment strategy against similar available alternatives. In circumstances where the "match" between the retail customer profile

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fact relating to the scope and terms of the relationship that must be disclosed pursuant to the Disclosure Obligation. *See* Section II.C.1.

and the recommendation appears less reasonable on its face (for example, where a retail customer's account objective is preservation of income and the recommendation involves higher risk, or where there are more significant conflicts of interest present), the more important the process will likely be for a broker-dealer to establish that it had a reasonable belief that the recommendation was in the best interest of the retail customer and did not place the broker-dealer's interest ahead of the retail customer. This could include reasonably designed policies and procedures to establish compliance with the Care Obligation, as required by the new Compliance Obligation, and could include maintaining supporting documentation for certain recommendations.[647]

Application of Care Obligation to Account Type Recommendations

As discussed above, Regulation Best Interest will apply to recommendations by a broker-dealer of a securities account type. Thus, the Care Obligation will require a broker-dealer to have a reasonable basis to believe that a recommendation of a securities account type (e.g., brokerage or advisory, or among the types of accounts offered by the firm) is in the retail customer's best interest at the time of the recommendation and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer.[648]

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647 *See supra* footnote 610 and accompanying text.

648 As discussed in Section II.B.2, whether and how Regulation Best Interest applies will depend on whether the financial professional making the recommendation is dually registered.

We believe broker-dealers would need to consider various factors in determining whether a particular account is in a particular retail customer's best interest. For example, broker-dealers generally should consider: (1) the services and products provided in the account (ancillary services provided in conjunction with an account type, account monitoring services, etc.); (2) the projected cost to the retail customer of the account; (3) alternative account types available; (4) the services requested by the retail customer; and (5) the retail customer's investment profile. Moreover, retail customer-specific factors, such as those identified in the definition of "Retail Customer Investment Profile," may not be applicable or available in every context, and would depend on the facts and circumstances at the time of account type recommendation. For example, one or more factors may have more or less relevance, or information about those factors may not be obtained or analyzed at all where the broker-dealer has a reasonable basis for believing that a particular factor is or is not relevant.[649] In addition, as discussed above, we recognize that factors other than cost may properly be considered when determining whether an account is in a retail customer's best interest.[650]

In the section that follows we discuss how the Care Obligation will apply to recommendations to open an IRA or to roll over assets into an IRA.

649 As discussed above, where a broker-dealer determines not to obtain or analyze one or more of the factors specifically identified in the definition of "Retail Customer Investment Profile," the broker-dealer generally should document its determination that the factor(s) are not relevant components of a retail customer's investment profile in light of the facts and circumstances of the particular recommendation.

650 *See id*.

Where the financial professional making the recommendation is dually registered (i.e., an associated person of a broker-dealer and a supervised person of an investment adviser (regardless of whether the professional works for a dual-registrant, affiliated firms, or unaffiliated firms)) the financial professional would need to make this evaluation taking into consideration the spectrum of accounts offered by the financial professional (i.e., both brokerage and advisory taking into account any eligibility requirements such as account minimums), and not just brokerage accounts. For example, all other things being equal, it may be in the retail customer's best interest to recommend a brokerage account to the retail customer who intends to buy and hold a long-term investment (e.g., maintain an account primarily composed of bonds or mutual funds and has a stated buy-and-hold strategy), as opposed to an advisory account (i.e., it may not be in the retail customer's best interest in this context to pay an ongoing fee for a security that he or she plans to hold to maturity).[651] On the other hand, it may not be in the retail customer's best interest to recommend a brokerage account where the retail customer plans to engage in at least a moderate level of trading and prefers to pay for advice in connection with such trading on the basis of a consistent recurring monthly or annual charge.[652] Furthermore, where a retail customer holds a variety of investments, or prefers differing levels of services (e.g., both episodic

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651 *See id.*

652 *See id.* We reiterate that this is a facts and circumstances determination, and that these examples are not meant to provide a bright line rule, but rather to illustrate certain considerations that a broker-dealer could consider when determining whether a recommended account type is in the best interest of the retail customer.

recommendations from a broker-dealer and continuous advisory services including discretionary asset management from an investment adviser), it may be in the retail customer's best interest to recommend both a brokerage and an advisory account.

Similarly, where the financial professional is only registered as an associated person of a broker-dealer (regardless of whether that broker-dealer entity is a dual-registrant or affiliated with an investment adviser), he or she would need to take into consideration only the brokerage accounts available.[653] However, even if a broker-dealer only offered brokerage accounts, the associated person would nevertheless need to have a reasonable basis to believe that the recommended account was in the best interest of the retail customer. For example, if the retail customer were seeking a relationship where the financial professional would have unlimited investment discretion (i.e., having responsibility for a customer's trading decisions),[654] the associated person would not have a reasonable basis to believe that a brokerage account was in the best interest of the retail customer. Thus, as with limited product menus, a limited selection of account types would not excuse a broker-dealer from making a recommendation not in the best interest of the retail customer.

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653 For example, if the natural person that is an associated person of the broker-dealer is not registered as an investment adviser representative, but is associated with a broker-dealer that is a dual-registrant, that associated person would only need to consider the brokerage accounts offered by the firm, and not the firm's advisory accounts in making the recommendation.

654 *See* Solely Incidental Interpretation.

Application of Care Obligation to IRA Rollovers and Related Recommendations

Regulation Best Interest also applies to recommendations to open an IRA or to roll over assets into an IRA. Thus, the Care Obligation will require a broker-dealer to have a reasonable basis to believe that the IRA or IRA rollover is in the best interest of the retail customer at the time of the recommendation and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer, taking into consideration the retail customer's investment profile and other relevant factors, as well as the potential risks, rewards, and costs of the IRA or IRA rollover compared to the investor's existing 401(k) account or other circumstances.[655]

When making a recommendation to open an IRA, or to roll over workplace retirement plan assets into an IRA rather than keeping assets in a previous employer's workplace retirement plan (or rolling over assets to a new employer's workplace retirement plan), broker-dealers should consider a variety of factors, the importance of which will depend on the particular retail customer's needs and circumstances. In addition to the *Factors to Consider Regarding a Recommendation to a Particular Retail Customer* discussed above, as well as the Retail Customer's Investment Profile, broker-dealers should consider a variety of additional factors specifically salient to IRAs and workplace retirement plans, in order to compare the retail customer's existing account to the IRA offered by the broker-dealer. These factors should

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655 *See infra* Section II.C.2; *see also* FINRA Regulatory Notice 13-45 (outlining several considerations regarding IRA rollovers).

generally include, among other relevant factors: fees and expenses; level of service available; available investment options; ability to take penalty-free withdrawals; application of required minimum distributions; protection from creditors and legal judgments; holdings of employer stock; and any special features of the existing account.[656] With respect to available investment options, we caution broker-dealers not to rely on, for example, an IRA having "more investment options" as the basis for recommending a rollover. Rather, as with other factors, broker-dealers should consider available investment options in an IRA, among other relevant factors, in light of the retail customer's current situation and needs in order to develop a reasonable basis to believe that the rollover is in the retail customer's best interest.

While these examples may be relevant to an analysis of available options, this list is not meant to be exhaustive. Furthermore, each factor generally should be analyzed with respect to a particular retail customer in order for a broker-dealer to form a reasonable belief that the recommendation is in the best interest of that retail customer and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer. Finally, as described above, certain factors may have more or less relevance, or not be relevant at all, depending on the particular facts and circumstances of each recommendation.

d. 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 the Retail Customer's Best Interest When Taken Together in Light of the Retail Customer's Investment Profile and

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656 *See id*.

Does Not Place the Interest of the Broker-Dealer Ahead of the Interest of the Retail Customer.

As proposed, the third component of the Care 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.[657] The Proposing Release noted that this requirement is intended to incorporate and enhance a broker-dealer's existing "quantitative suitability" obligation by applying the requirement 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."[658]

We received a few comments suggesting modifications to this component of the obligation. For example, one commenter recommended the Commission clarify the meaning of "series of transactions," while a second commenter requested a carve-out for "active traders" who are "interested in trading individual stocks… with a great degree of regularity."[659] Another

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657 Proposing Release at 21613.

658 Proposing Release at 21613-21614.

659 *See* Letter from Keith Lampi, President, Alternative and Direct Investment Securities Association ("ADISA") (Aug. 7, 2018) ("ADISA Letter") (recommending the Commission clarify the meaning of "series of transactions"); Letter from Joseph C.

commenter maintained that the quantitative suitability obligations should only apply to those accounts over which the member firm has "control," and that if the Commission does not include the control element of FINRA Rule 2111 as part of the Care Obligation, that the Commission "should at a minimum confirm that this requirement applies only to recommendations by a single associated person, not across multiple associated persons at the firm who act independently."[660]

After considering these comments, the Commission is adopting the proposed "quantitative care" component of the Care Obligation as proposed. As noted in the Proposing Release, we believe that imposing the quantitative care obligation without a "control" element would provide consistency in the investor protections provided to retail customers 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.[661] This would also be consistent with the other components of the Care Obligation, which apply regardless of whether a broker-dealer "controls" or exercises "*de facto* control" over the retail customers' account.

While the Commission appreciates the concern raised about "active traders" and the concern relating to a retail customer that could maintain several accounts at the same firm, we

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Cascarelli, Corporate Counsel, Network 1 Financial Securities (Aug. 7, 2018) ("Network 1 Letter") (suggesting a "carve-out exemption formula" from Regulation Best Interest to accommodate investors and their stockbrokers who specialize in "active trading").

660 SIFMA August 2018 Letter.

661 *See* Proposing Release at 21613-21614.

nevertheless believe that retail customers could, and should, benefit from the protections of this requirement, namely the 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.[662] As we indicated in the Proposing Release, the fact that a customer may have *some* knowledge of financial markets or *some* "control" should not absolve the broker-dealer of the ultimate responsibility to have a reasonable basis to believe that any *recommendations it makes* are in the best interest of the retail customer.[663] Where a retail customer expresses a desire for "active trading,"[664] a broker-dealer may take this factor into consideration when evaluating a recommendation; however, the broker-dealer will nevertheless need to reasonably believe that a series of recommended transactions is in the best interest of the retail customer. We further note that Regulation Best Interest does not require a broker-dealer to refuse to accept a customer's order that is contrary to the broker-dealer's recommendation. Nor does Regulation Best Interest apply to self-directed or otherwise unsolicited transactions by a retail customer, whether or not he or she also receives separate recommendations from the broker-dealer.

With respect to the concern about applying the requirement "only to recommendations by a single associated person, not across multiple associated persons at the firm who act

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662 *See id*.

663 *See id*.

664 *See* Network 1 Letter.

independently,"[665] we note that both the firm and their associated persons have to comply with the Care Obligation. If we took this commenter's suggestion, we are concerned we would potentially create a loophole and a perverse outcome that would allow for avoidance of the Care Obligation, and permit potentially excessive trading, by encouraging recommendations across a number of associated persons. We reiterate our position that, consistent with the other components of the Care Obligation under the Care Obligation, when a series of transactions is recommended to a retail customer, a broker-dealer must evaluate whether the series of recommended transactions places the broker-dealer's interest ahead of the retail customer's—this is true for both the associated person making the recommendation, as well as for the firm.[666] This will necessarily depend on the facts and circumstances of each particular recommendation, and of each particular series of transactions; however, we note that, as part of developing a retail customer's investment profile, a broker-dealer is required to exercise reasonable diligence to ascertain the retail customer's investment profile, which would include seeking to obtain and analyze a retail customer's other investments.[667]

Finally, with respect to the meaning of series of recommended transactions, what would constitute a "series" of recommended transactions would depend on the facts and circumstances, and would need to be evaluated with respect to a particular retail customer. In other words, a

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665 *See* SIFMA 2018 Letter.

666 *See* Proposing Release at 21613-21614.

667 *See supra* Section II.C.2.c.

broker-dealer would need to reasonably believe that the level of trading (series of recommended transactions) is appropriate for a particular retail customer, and thus a bright line definition across all retail customers would be unworkable. Moreover, providing a bright line definition could encourage firms to focus on a particular number of transactions rather than focusing on ensuring that a series of recommendations, taken together, are in the best interest of the retail customer. Finally, a "series" of recommended transactions is an established term under the federal securities laws and SRO rules that is evaluated in concert with existing guideposts, such as turnover rate,[668] cost-to-equity ratio,[669] and use of in-and-out trading,[670] which have been developed over time and which serve as indicators of excessive trading.

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668 *See, e.g., Carras v. Burns*, 516 F.2d 251, 258 (4th Cir. 1975); *Shearson Lehman Hutton Inc.*, 49 S.E.C. 1119, 1122 at footnote 10 (1989); *Laurie Jones Canady*, 54 S.E.C. 65, 74 (1999), Exchange Act Release No. 41250 (Apr. 5, 1999) (using the turnover rate for relevant period), *petition denied*, 230 F.3d 362 (D.C. Cir. 2000).

669 *See, e.g., Shearson Lehman*, 49 S.E.C. at 1121 (stating that "[o]ne test for excessive trading is the relationship between the account opening balance and the amounts of markups, commissions, and margin charges"); *Michael E. Tennenbaum*, 47 S.E.C. 703 (Jan.19, 1982).

670 *See*, *e.g.*, *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 435-36 (N.D. Cal. 1968), *modified in part and aff'd*, 430 F.2d 1202 (9th Cir. 1970); *R.H. Johnson & Co.*, 36 S.E.C. 467 (1955); *Behel, Johnson & Co.*, 26 S.E.C. 163 (1947). *Cody v. S.E.C.*, 693 F.3d 251, 260 (1st Cir. 2012).

3. Conflict of Interest Obligation

We proposed the Conflict of Interest Obligation to require a broker-dealer entity[671] to: (1) establish, maintain, and enforce written policies and procedures reasonably designed to identify, and disclose, or eliminate all material conflicts of interest 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. This proposed approach reflected our view that establishing reasonably designed policies and procedures is critical to identifying and addressing conflicts of interest. In addition, the proposed approach would serve the Commission's goal of addressing conflicts of interest that may harm investors while providing flexibility to establish systems tailored to broker-dealers' business models.

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671 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 Conflict of Interest Obligation (and the Compliance Obligation discussed in Section II.C.4 below) 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 and the Compliance Obligation, 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 conflicts (as defined in paragraph (c)(3) of the rule) 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.

The Commission solicited comment on the Conflict of Interest Obligation, including the specific requirements to create policies and procedures with respect to disclosure, mitigation, and elimination of conflicts of interest. Commenters requested changes to several aspects of the Conflict of Interest Obligation, including providing more clarity and guidance surrounding when specific conflicts need to be disclosed, mitigated or eliminated.[672]

In consideration of these comments, we are adopting the Conflict of Interest Obligation with revisions to: (1) create an overarching obligation to establish written policies and procedures to identify and at a minimum disclose, pursuant to the Disclosure Obligation, or eliminate all conflicts of interest associated with the recommendation; and (2) require broker-dealers to establish policies and procedures to be reasonably designed to mitigate or eliminate certain identified conflicts of interest.

In addition to the overarching obligation, we specifically require broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to: (i) identify and mitigate any conflicts of interest associated with 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 or dealer, or such natural person making the recommendation, ahead of the interest of the retail customer; (ii) (A) identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended (i.e. only make

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672 *See, e.g.,* SIFMA August 2018 Letter; Primerica Letter; BISA Letter; CCMC Letters; Wells Fargo Letter.

recommendations of proprietary or other limited range of products) to a retail customer and any conflicts of interest associated with such limitations, in accordance with the Disclosure Obligation, and (B) 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 (iii) identify and eliminate any conflicts of interest associated with sales contests, 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.[673]

Each of these changes and the requirements pursuant to the Conflict of Interest Obligation is discussed in more detail below.

a. Reasonably Designed Policies and Procedures

We proposed to require broker-dealers to establish reasonably designed policies and procedures as we believe they are critical to identifying and addressing conflicts of interest[674] and helping ensure compliance with the requirements to disclose conflicts of interest pursuant to

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673 Rule 15*l*-1 under the Exchange Act.

674 *See* FSI August 2018 Letter ("Experience shows that investors already ignore much of the enormous volume of regulatory disclosures they are being provided. Instead, a more realistic approach is to require broker-dealers to adopt written supervisory procedures to detect and manage conflicts of interest, to avoid those they can and take steps to mitigate the impact of those conflicts that can't be avoided.").

the Disclosure Obligation.[675] In addition, policies and procedures may minimize compliance costs that may be passed on to retail customers.[676] As discussed in the Proposing Release, it would be reasonable for broker-dealers to use a risk-based compliance and supervisory system rather than requiring a detailed review of each recommendation and to have flexibility to tailor policies and procedures to their specific business models. The Commission also provided guidance on components a broker-dealer should consider including in its program with regard to the Conflict of Interest Obligation.[677]

In response to the proposed policies and procedures requirement, some commenters asserted that it was an effective means of addressing conflicts[678] while others were concerned that the Commission was providing too much flexibility in addressing conflicts of interest.[679] A

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675 *See* Proposing Release at Section II.D.3.b. *See also* CCMC Letters (policies and procedures requirement should assist broker-dealers in managing the potential impact of conflicts of interest); FPC Letter (acknowledging the importance of firms' policies and procedures when providing financial planning to act in the client's best interest).

676 *See* Proposing Release at Section II.D.3.b. *See also* Cambridge Letter ("Cambridge believes the SEC's goals of facilitating disclosure and mitigating material conflicts of interest, while minimizing additional compliance costs that may be passed on to the retail customers can best be accomplished by requiring broker-dealers to adopt written supervisory procedures to detect and manage conflicts of interest, to avoid those they can and take steps to mitigate the impact of those conflicts that can't be avoided.").

677 Proposing Release at Section II.D.3.b.

678 *See* Fidelity Letter; SIFMA August 2018 Letter; Morgan Stanley Letter.

679 *See, e.g.,* NASAA August 2018 Letter; CFA Institute Letter; Galvin Letter; Better Markets August 2018 Letter (policies and procedures should be "actually designed" to achieve those ends, not just "reasonably designed" to do so). *But see* IRI Letter ("The

few commenters expressed agreement with allowing a flexible risk-based approach tailored to a broker-dealer's business model as opposed to a detailed review of each recommendation.[680] A few commenters expressed concern with the Commission's assertion that policies and procedures may minimize compliance costs that may be passed on to retail customers, noting the uncertainty surrounding how conflicts of interest should be addressed by policies and procedures.[681] One commenter suggested that the Commission should adopt a safe harbor for the Conflicts of Interest Obligation by demonstrating compliance with certain existing FINRA rules.[682] As discussed below under the new Compliance Obligation, some commenters suggested that the policies and procedures requirement should apply to aspects of the entire rule.[683]

In consideration of the comments received, we are adopting the approach with respect to reasonably designed policies and procedures to identify and address conflicts of interest set forth in the proposal substantially as proposed. As stated in the Proposing Release, we believe that

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Conflict of Interest Obligation should be simplified and streamlined to give BDs the flexibility to determine appropriate steps to manage material conflicts.").

680 *See* Cambridge Letter; CCMC Letters. *But see* NASAA August 2018 Letter (suggesting the Commission reconsider the risk-based approach to comply with its duties).

681 *See, e.g.,* Better Markets August 2018 Letter; CFA Institute Letter.

682 *See* AXA Letter.

683 *See, e.g.,* NASAA August 2018 Letter (suggesting that, at a minimum, a firm's policies and procedures should require an analysis of the costs and risks of a product as well as the client's financial goals).

broker-dealers should have flexibility to tailor their policies and procedures to their particular business model, focusing on specific areas of their business that pose the greatest risk of noncompliance and greatest risk of potential harm to retail customers as opposed to a detailed review of each recommendation.[684]

While we recognize a commenter's statement[685] that policies and procedures should be "actually designed" to address conflicts of interest, we do not believe that the design of policies and procedures should be measured against a standard of strict liability, but should instead be measured against a standard of reasonableness. In addition, we believe that policies and procedures are an effective tool to identify and address conflicts of interest, and would allow the Commission to identify and address potential compliance deficiencies or failures (such as inadequate or inaccurate policies and procedures, or failure to follow the policies and procedures) early on, reducing the chance of retail customer harm.[686] We also believe that there is no one-size-fits all framework, and, as such, broker-dealers should have flexibility to reasonably design their policies and procedures to tailor them to account for their business model, given the structure and characteristics of their relationships with retail customers, including the varying levels and frequency of recommendations provided and the types of conflicts that may be presented. This requirement of "reasonably designed" policies and procedures is also

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684 *See* Proposing Release at II.D.3.b.

685 *See* Better Markets August 2018 Letter.

686 *See infra* footnote 809.

consistent with Commission rules and regulations in other contexts, including under the Advisers Act.[687] Further, the Commission continues to believe that while not required components, as an effective practice, broker-dealers should consider including in their supervisory and compliance programs the components listed in the Proposing Release, which may be relevant in considering whether policies and procedures are reasonably designed.[688]

The Commission is not providing a safe harbor to Regulation Best Interest for broker-dealers who demonstrate compliance with FINRA rules[689] because, while FINRA rules may address specific conflicts of interest, Regulation Best Interest establishes a broader obligation to address conflicts both at the firm level and at the associated person level.[690] As to commenters' concerns that the policies and procedures requirement provides too much flexibility and as

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687 *See* Rule 206(4)-7 under the Advisers Act. *See also* Section 15(g) of the Exchange Act; 15E(g) of the Exchange Act.

688 These components could include, among other things: policies and procedures outlining how the firm identifies conflicts, identifying such conflicts and specifying how the broker-dealer intends to address each conflict; robust compliance and monitoring systems; processes to escalate identified instances of noncompliance for remediation; procedures that designate responsibility to business line personnel for supervision of functions and persons, including determination of compensation; processes for escalating conflicts of interest; processes for periodic review and testing of the adequacy and effectiveness of policies and procedures; and training on policies and procedures. Proposing Release at Section II.D.3.b.

689 *See supra* footnote 682.

690 "While FINRA has repeatedly emphasized the importance of identifying and managing conflicts and has a number of rules that address discrete conflicts of interest, there is currently no similarly broad conflicts provision in FINRA rules, including the suitability rule." *See* FINRA 2018 Letter.

discussed in more detail below, the Commission has changed the specific requirements to be addressed by the policies and procedures pursuant to the Conflict of Interest Obligation to provide more certainty to firms on which conflicts of interest should be addressed through disclosure, mitigation or elimination. While the Commission also understands concerns related to compliance costs, we believe that the revisions to the Conflict of Interest Obligation, including the greater specificity in the rule text, as well as the guidance provided below, will ease the adjustment of broker-dealers' existing supervisory and compliance systems and streamline compliance with Regulation Best Interest.

b. Conflicts of Interest

The Proposing Release distinguished between material conflicts of interest in general and material conflicts of interest arising from financial incentives. Under the Proposing Release, broker-dealers would be required to establish, maintain, and enforce policies and procedures to identify and, in the case of material conflicts of interest, disclose or eliminate, and in the case of financial incentives, disclose and mitigate, or eliminate material conflicts of interest arising from financial incentives.[691]

The Commission proposed to interpret a material conflict of interest as a conflict of interest that a reasonable person would expect might incline a broker—consciously or

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691 *See* Proposing Release at Section II.D.3.

unconsciously—to make a recommendation that is not disinterested.[692] For material conflicts of interest arising from financial incentives associated with a recommendation, the Proposing Release discussed 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.[693]

In addition, the Commission proposed to limit conflicts of interest to those associated with recommendations as broker-dealers may provide a range of services not involving a

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692 Proposing Release at 21602.

693 *Id.*

recommendation, and such services are subject to general antifraud liability and specific requirements to address associated conflicts of interest.[694]

Recognizing the phrase "financial incentives" could be interpreted broadly, the Commission solicited comment on the proposed requirement and the distinction between the different requirements under the Conflict of Interest Obligation. In response, many commenters suggested that the scope of the description of financial incentives be narrowed as it was too broad and requested guidance or examples of material conflicts of interest that would not fall within the description of financial incentives.[695] Specifically, a number of commenters suggested that the mitigation obligation should focus on financial incentives at the registered representative level as opposed to the firm level.[696] A number of commenters suggested that the distinction between material conflicts and financial incentives should be removed altogether.[697] Commenters also stated that the mitigation requirement is a higher standard of conduct than the

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694 *See* Proposing Release at 21617. In including this limitation, the Commission explained that it was not intending to change the disclosure obligations associated with these services under the general antifraud provisions of the federal securities laws.

695 *See, e.g.,* SIFMA August 2018 Letter; Primerica Letter; BISA Letter; Committee of Annuity Insurers Letter; IPA Letter; CFA Institute Letter.

696 *See, e.g.,* Primerica Letter; TIAA Letter; ICI Letter; Invesco Letter; Money Management Institute Letter; Committee of Annuity Insurers Letter.

697 *See, e.g.,* CFA August 2018 Letter; CFA Institute Letter; Morgan Stanley Letter; SIFMA August 2018 Letter; CCMC Letters.

investment adviser fiduciary duty which allows for conflicts to be addressed through disclosure sufficient for informed consent.[698]

In consideration of comments and as discussed in more detail below, the Commission has restructured the Conflict of Interest Obligation to: (1) create an overarching obligation to establish, maintain and enforce written policies and procedures that are reasonably designed to identify and at a minimum disclose (pursuant to the Disclosure Obligation), or eliminate, all conflicts of interest associated with the recommendation; and (2) adopt specific requirements with respect to such policies and procedures for the mitigation and elimination of identified conflicts of interest.

In particular, we have revised the proposed policies and procedures requirement for mitigation to focus on conflicts of interest that create an incentive for an associated person to place his or her interests ahead of the interest of the retail customer as described below, by eliminating the distinction between material conflicts of interest and material conflicts of interest

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698 *See* Franklin Templeton Letter (stating that by including this heightened requirement for financial conflicts of interest, Regulation Best Interest would impose a higher standard on broker-dealers than is required of investment advisers with respect to such conflicts); Primerica Letter (stating that by requiring broker-dealers to disclose and mitigate or eliminate conflicts resulting from financial incentives, the standard is actually higher than the standard that applies under the Advisers Act); CCMC Letters (stating that the requirement to mitigate or eliminate material conflicts of interest arising from financial incentives effectively subjects broker-dealers to a higher standard than investment advisers, who are generally able to disclose conflicts of interest). *See also* UBS Letter; ASA Letter. Some commenters also suggested that the obligation to address conflicts of interest should be harmonized between broker-dealers and investment advisers. *See, e.g.,* Schwab Letter.

arising from financial incentives, and removing the affirmative mitigation requirement at the firm level. However, in light of this change, we are adding a new provision requiring broker-dealers to establish, maintain, and enforce written policies and procedures to specifically require broker-dealers to identify and disclose material limitations, and any associated conflicts of interest a broker-dealer places on the securities or investment strategies involving securities that may be recommended to the retail customer, such as recommendations being based on limited product menus (i.e., only make recommendations of proprietary or other limited range of products) and prevent such limitations and associated conflicts of interest from causing the broker-dealer to make recommendations that place its interest ahead of the retail customer. We believe the policies and procedures need to address those certain conflicts of interest inherent in the broker-dealer business model by heightened measures in order to prevent recommendations that are not in the best interest of the retail customer. Therefore, we are adding a provision requiring broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and to eliminate any conflicts of interest associated with sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.

For purposes of Regulation Best Interest, and for the reasons described in more detail in the context of the Disclosure Obligation, we have also amended the rule text by eliminating

"material" from "conflict of interest" and codified the definition of a conflict of interest[699] to mean an interest that might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested.[700] While "material" has been eliminated, pursuant to the Disclosure Obligation, broker-dealers are required to disclose all material facts relating to conflicts of interest associated with recommendations, consistent with the Proposing Release's intent of facilitating disclosure to assist retail customers in making informed investment decisions.[701]

Regarding the application of the Conflict of Interest Obligation only to those conflicts of interest associated with recommendations, one commenter stated that given the lack of detail in the Proposing Release, broker-dealers may have difficulty determining whether material conflicts are associated with a recommendation and how to adequately address such conflicts, which could create inconsistent application of Regulation Best Interest.[702] We continue to

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699 *See* Section II.D.1. To provide clarity that the interpretation of "conflict of interest" is limited to Regulation Best Interest, the Commission has revised the rule text to include a definition of the term.

700 *See id*.

701 *Id.*

702 *See* State Attorneys General Letter. ("Given the lack of detail in the Proposed Rule, broker-dealers may have difficulty determining whether material conflicts are (1) "associated with recommendations" and therefore subject to disclosure or elimination; or (2) "arising from financial incentives associated with such recommendations" and therefore subject to disclosure and mitigation, or elimination. This ambiguity, while designed to give maximum flexibility to broker-dealers, may in fact result in inconsistent application of the Proposed Rule nationwide and further add to the existing confusion.")

believe this approach is appropriate, for the reasons discussed in the Proposing Release[703] and also believe that our revised Conflict of Interest Obligation provides more specificity about how to address specific conflicts of interest, in conjunction with our Disclosure Obligation, which should address commenters' concerns.

c. Identifying Conflicts of Interest

In the Proposing Release, the Commission stated that having a process to identify and appropriately categorize conflicts of interest is a critical first step to ensure that broker-dealers have reasonably designed policies and procedures to address conflicts of interest in order to comply with the Conflict of Interest Obligation. As stated in the Proposing Release, reasonably designed policies and procedures to identify conflicts of interest generally should do the following: (i) define such conflicts in a manner that is relevant to a broker-dealer's business (i.e., conflicts of both the broker-dealer entity and the 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 conflicts that the broker-dealer (and associated persons of the broker-dealer) may face; (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 or services) and regular, periodic (e.g., annual) review for the

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703 *See* Proposing Release at 21618.

identification of conflicts associated with the broker-dealer's business; and (v) establish training procedures regarding the broker-dealer's conflicts of interest, including conflicts of natural persons who are associated persons of the broker-dealer, how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest.[704] Most commenters did not express a view on such guidance relating to the process of identifying conflicts of interest. Therefore, for the reasons discussed in the Proposing Release, we are reiterating this guidance here.

d. Overarching Obligation Related to Conflicts of Interest

As proposed, the first component of the Conflict of Interest Obligation would have required a broker-dealer to 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. In guidance, the Commission stated that reasonably designed policies and procedures 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.

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704 *Id.*

As such, the requirement was intended to provide flexibility to broker-dealers regarding how to address conflicts of interest, whether through disclosure pursuant to the Disclosure Obligation, or elimination. The Commission also indicated that there may be situations in which disclosure alone is not sufficient, and broker-dealers may need to establish policies and procedures designed to eliminate the conflict or both disclose and mitigate it.[705] The Commission also provided examples of how a broker-dealer could eliminate a conflict.[706]

As discussed above, we received many comments generally on the Conflict of Interest Obligation, requesting clarification on which conflicts needed to be disclosed, versus those that should be mitigated or eliminated.[707] Some commenters suggested that disclosure and informed consent should be considered to effectively address conflicts, similar to the approach taken under the Advisers Act.[708] Some commenters suggested that disclosure alone was sufficient to address conflicts arising from financial incentives.[709] For example, a few commenters identified specific types of conflicts they believed could be addressed by appropriate disclosure, such as third-party

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705 *See* Proposing Release at 21619-21620.

706 *Id.*

707 *See supra* footnote 672.

708 *See* IPA Letter; Morgan Stanley Letter; ASA Letter.

709 *See, e.g.,* Committee of Annuity Insurers Letter; Stifel Letter; Mass Mutual Letter; SIFMA August 2018 Letter; HD Vest Letter; Primerica Letter.

payments.[710] A few commenters requested that the examples of how to eliminate conflicts of interest in the Proposing Release be removed.[711]

After carefully considering comments, we are adopting, similar to the Proposing Release, an overarching requirement to establish, maintain, and enforce reasonably designed policies and procedures to identify and, at a minimum, disclose, in accordance with the Disclosure Obligation, or eliminate all conflicts of interest associated with the recommendation. However, as discussed in the following sections, we are otherwise revising the Conflict of Interest Obligation in response to these comments. Subparagraphs (a)(2)(iii)(B)-(D) of the rule text will now require policies and procedures that are reasonably designed to address specific conflicts of interest in areas that we believe create greater incentives for, and increased risk that, the broker-dealer or associated person may place its or his or her own interest ahead of the retail customer's interest, specifically conflicts of interest that: (1) create certain incentives to associated persons; (2)

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710 *See, e.g.*, Invesco Letter; Transamerica August 2018 Letter; Primerica Letter.

711 *See, e.g.*, ICI Letter ("This example suggests a firm that offers proprietary funds should consider relinquishing the advisory fees the firm or its affiliate receives for managing those funds as a means to address conflicts that selling such funds creates. This example is inconsistent with the SEC's explicit statements elsewhere in the Best Interest Proposal that Regulation Best Interest would not preclude a firm from offering proprietary products….The SEC should clarify in any adopting release that firms selling proprietary funds are not obligated to credit fund advisory fees against other broker-dealer charges. The ability to charge fees to manage proprietary funds is critical to preserve the ability of firms to offer both proprietary and third-party funds."); Committee of Annuity Insurers Letter ("This suggested method for elimination of material conflicts of interest relating to affiliated mutual funds presents a number of problematic issues….This example is exacerbated in the context of variable annuities.").

conflicts of interest associated with material limitations on the securities or investment strategies involving securities, such as, limited product menus; and (3) sales contests, sales quotas, bonuses, and non-cash compensation based on the sales of specific securities or type of security within a limited period of time.

In adopting this overarching requirement, we are reaffirming guidance in the Proposing Release on establishing a process to identify and determine how to address a conflict, as discussed above.[712] Further, similar to the Proposing Release, while we are not requiring broker-dealers to develop policies and procedures to disclose and mitigate *all* conflicts of interest, we are requiring that broker-dealers develop policies and procedures reasonably designed to "*at a minimum disclose*, or eliminate" all conflicts.[713] We continue to believe that where a broker-dealer cannot fully and fairly disclose a conflict of interest in accordance with the Disclosure Obligation, the broker-dealer should eliminate the conflict or adequately mitigate (i.e., reduce) the conflict such that full and fair disclosure in accordance with the Disclosure Obligation is possible. In some cases, conflicts of interest may be of a nature and extent that it would be difficult to provide disclosure that adequately conveys to a retail customer the material facts or the nature, magnitude and potential effect of the conflict for informed decision-making or where disclosure may not be sufficiently specific or comprehensible for the retail customer to

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712 *See* Section II.C.3.c.

713 Proposing Release at 21620.

understand whether and how the conflict will affect the recommendations he or she receives.[714] Also, in certain situations, a broker-dealer, even if not required, may determine that in addition to addressing a conflict through disclosure, to take additional steps beyond disclosure to also mitigate the conflict of interest.

The Commission acknowledges commenters' concerns regarding the examples of how to eliminate conflicts of interest that were provided in the Proposing Release. The Commission's intent was not to prevent firms from offering certain products to the extent that they are in a retail customer's best interest. In order to avoid confusion and to respond to commenters, we are not including these examples as final guidance here as we have instead decided to focus the rule text on specific conflicts of interest associated with certain sales practices based on the sale of specific securities that we require to be eliminated and thus such examples are not necessary. In discussing the separate mitigation and elimination requirements below, we provide guidance on the specific conflicts for which we are requiring these heightened measures beyond disclosure. However, while we have removed the examples of potential conflicts of interest that may be more appropriately avoided, we emphasize that pursuant to the overarching obligation, elimination of conflicts of interest is one method of addressing the conflict, in lieu of disclosure,

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714 *See id.*; *see also* Fiduciary Interpretation (stating that where an investment adviser cannot fully and fairly disclose a conflict such that the client can provide informed consent, the adviser should *eliminate* the conflict or adequately *mitigate* (i.e., modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible).

which broker-dealers may find appropriate in certain circumstances even when not required by Regulation Best Interest.

e. Mitigation of Certain Incentives to Associated Persons

We proposed to require firms 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 with such recommendations. In proposing this requirement, we recognized the importance of the brokerage model as a potentially cost-effective option for investors, acknowledging that the compensation structures and arrangements within the business model create inherent conflicts[715] but that such compensation may be appropriate in light of the time and experience necessary to understand investments. As such, we aimed to promote investor choice and access to products and instead of requiring broker-dealers to establish policies and procedures to eliminate compensation structures and arrangements,[716] required policies and procedures to mitigate those conflicts of interest.

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715 *See* Proposing Release at II.D.3.e. *See also* Tully Report.

716 While the Commission's goal is to promote access and choice to investors, as discussed in more detail in Section II.C.3.g, Elimination of Certain Conflicts of Interest, the Commission believes it is in the public interest and will enhance investor protection to require broker-dealers to reasonably design policies and procedures to eliminate certain conflicts of interest as we believe such conflicts create too strong of an incentive for a broker-dealer to make a recommendation that places the broker-dealer's interest ahead of the retail customer's interest.

We proposed a principles-based approach to provide flexibility to firms to develop and tailor policies and procedures that included conflict mitigation measures based on each firm's circumstances, for example, the size, retail customer base, nature and significance of the conflict, and complexity of the product.[717] We stated that, depending on the conflict and the firm's assessment, more or less demanding measures may be appropriate.[718] We provided examples of situations in which heightened mitigation measures may be appropriate and also suggested that broker-dealers assess their policies and procedures as they may be reasonably designed at the outset but may later cease to be reasonably designed based on subsequent events or information.[719] Finally, we provided a non-exhaustive list of potential practices that we believe broker-dealers should consider including in their policies and procedures, and as discussed above, suggested that some practices may be more appropriately avoided as they may be difficult to mitigate.[720]

As discussed above, many commenters expressed concern with the breadth of the mitigation requirement and requested that mitigation be limited to certain types of

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717 Proposing Release at II.D.3.e.

718 *Id.*

719 *Id.*

720 *Id.*

compensation[721] or solely to financial incentives to the individual registered representative.[722] Many commenters were also concerned about what they described as ambiguities in the Proposing Release, including the lack of a definition of the term "mitigate"[723] and requested further guidance surrounding conflicts that needed to be mitigated versus those that can be disclosed.[724] Some commenters suggested that supervision should be adequate mitigation and requested clarification on whether their existing supervisory practices, if compliant, were sufficient.[725] As discussed above under Section II.C.3.b, a number of commenters expressed

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721 *See, e.g.,* Cetera August 2018 Letter; SIFMA August 2018 Letter. *But see* CFA August 2018 Letter (stating that the Commission has proposed an appropriately broad definition of material conflicts that arise out of financial incentives and that it should not be narrowed but a cleaner approach would be to eliminate the artificial distinction between those material conflicts of interest that arise from financial incentives and those that do not, and to apply the same obligation to disclose and mitigate all material conflicts, whatever the source).

722 *See, e.g.,* Primerica Letter; Committee of Annuity Insurers Letter; Cetera August 2018 Letter. *See also* Wells Fargo Letter (stating that receipt of fees and other revenue that does not otherwise result in a direct financial incentive at the registered representative level should be disclosed); ICI Letter (recommending revisions to the proposed conflict of interest obligation to focus the mitigation obligation on the fees, revenue, or other financial incentives that may influence the recommendation of a broker-dealer representative − the individual making the recommendation); Invesco Letter.

723 *See*, *e.g.,* UVA Letter.

724 *See, e.g.,* CFA August 2018 Letter; Wells Fargo Letter; Committee of Annuity Insurers Letter; NASAA August 2018 Letter; Cetera August 2018 Letter; Morningstar Letter.

725 *See, e.g.,* BISA Letter; AALU Letter; Primerica Letter; Committee of Annuity Insurers Letter.

concern that the mitigation requirement is a higher standard of conduct than the investment adviser fiduciary duty and requested that it be aligned with the fiduciary duty.[726]

Many commenters expressed concern over some of the examples, and in particular neutral compensation factors, described as a potential mitigation measure.[727] Similarly, some commenters suggested that the Commission should take more of a principles-based approach as they viewed the Proposing Release as too prescriptive because it incorporated examples from the DOL Fiduciary Rule.[728] One commenter expressed concern over the suggestion that heightened mitigation may be appropriate if a retail customer has a less sophisticated understanding, stating that it is unclear how mitigation would be measured and could create heightened costs and risks for firms.[729] Finally, some commenters requested confirmation that certain practices are

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726 *Supra* footnote 698.

727 *See, e.g.,* SIFMA August 2018 Letter; ICI Letter; Edward Jones Letter; Morgan Stanley Letter; Transamerica August 2018 Letter; Ameriprise Letter; Capital Group Letter; Cetera August 2018 Letter; CCMC Letters; Letter from Michelle Bryan Oroschakoff, Chief Legal Officer, LPL Financial (Dec. 18, 2018) ("LPL December 2018 Letter") (requesting confirmation that the non-exhaustive list of potential practices was intended merely as a list of examples and are not required mitigation practices); Mass Mutual February 2019 Letter. But *see* NASAA August 2018 Letter (stating that neutral compensation across products could constitute appropriate mitigation), State Attorneys General Letter (suggesting differential compensation be permitted based solely on neutral factors).

728 *See, e.g.,* LPL August 2018 Letter; Cetera August 2018 Letter; Davis Harman Letter.

729 *See* Primerica Letter.

permissible such as use of compensation grids,[730] receipt of revenue sharing,[731] differential compensation,[732] recommendations based on a limited range of products and proprietary products,[733] and use of employment benefits.[734]

In response to commenters, we have revised the Proposing Release's requirement with respect to mitigation to require broker-dealers to establish policies and procedures reasonably designed to 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- dealer to place the interest of the broker-dealer, or such natural person ahead of the interest of the retail customer.

We agree with commenters that it is appropriate to focus on the incentives that directly affect the associated person making a recommendation, because we believe those conflicts are most likely to undermine the associated person's ability to make a recommendation that is in the best interest of the retail customer, and thus present heightened risk of recommendations that are

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730 *See, e.g.,* SIFMA August 2018 Letter; Committee of Annuity Insurers Letter; Primerica Letter.

731 *See, e.g.*, SIFMA August 2018 Letter; Cetera August 2018 Letter.

732 *See, e.g.,* Cetera August 2018 Letter; Transamerica August 2018 Letter; Ameriprise Letter.

733 *See, e.g.,* NY Life Letter; Fidelity Letter; ICI Letter; T.Rowe Letter. These commenters suggested that disclosure would be an appropriate way to address conflicts of interest associated with limited product menus and proprietary products.

734 *See, e.g.,* AALU Letter.

not in a retail customer's best interest and that place the associated person's or firm's interests ahead of the retail customer's interest.

While disclosure can be an effective tool for retail customers to increase awareness of a conflict of interest,[735] in certain cases, we do not believe that disclosure alone sufficiently reduces the potential effect that these conflicts of interest may have on recommendations made to retail customers.[736] Instead, we believe that broker-dealers are most capable of identifying and addressing the conflicts that may affect the obligations of their associated persons with respect to the recommendations they make, and therefore are in the best position, to affirmatively reduce the potential effect of these conflicts of interest such that they do not taint the recommendation.

We are persuaded by commenters[737] that expressed concern that requiring broker-dealers to establish policies and procedures reasonably designed to mitigate all financial incentives, including any compensation, may result in broker-dealers narrowing their product shelf and

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735 *See* Section II.C.1, Disclosure Obligation; Relationship Summary Adopting Release.

736 *See, e.g.,* Tully Report; CFA August 2018 Letter; AARP August 2018 Letter; Warren Letter ("the [Commission] should not rely on disclosure alone to protect consumers."). *See also* DOL Fiduciary Rule Release at 20950. "Disclosure alone has proven ineffective to mitigate conflicts in advice."

737 *See, e.g.,* Primerica Letter ("The SEC's current formulation of the conflicts obligation thus inappropriately, and we believe unintentionally, preferences advisory models over brokerage models."); Transamerica August 2018 Letter (expressing concern that the proposed interpretation of financial incentives is overbroad and may result in broker-dealers narrowing their product shelf, which seems inconsistent with the SEC's stated goal of preserving the broker-dealer model to protect an investor's right to choose between brokerage and advisory accounts).

compensation practices which would be inconsistent with the Commission's stated goal.[738] As stated in the Proposing Release, while the Commission's goal in adopting Regulation Best Interest is to enhance investor protection by reducing the potential harm to retail customers from conflicts of interest that may affect broker-dealer recommendations, we want to do so while preserving, to the extent possible, access and choice for investors who prefer to pay for investment recommendations on a transaction-by-transaction basis, which is the "pay as you go" model that broker-dealers generally provide, as well as preserving retail customer choice of the level and types of advice provided and the products available.[739] As such, transaction based-compensation need not be eliminated pursuant to Regulation Best Interest.

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738 The Commission recognizes that a broker-dealer's financial or other interest can and will inevitably exist.

739 We are persuaded by commenters regarding the competitive issues for broker-dealers that could arise if we require mitigation of firm-level financial incentives, which is not required by an investment adviser's fiduciary duty, and could further encourage migration from the broker-dealer to investment adviser model and result in a loss of choice for retail customers. *See* Section I; CCMC Letters ("Imposing a standard on broker-dealers with respect to managing conflicts of interest that is greater than that imposed on investment advisers, on top of the additional regulatory obligations to which broker-dealers are subject that are not imposed on investment advisers, threatens to undermine the SEC's objective of preserving retail customer choice and access to the brokerage advice model and may introduce a new source of confusion when it comes to investors' understanding of the duties they are owed."); AALU Letter ("Overly-rigid mitigation requirements could limit consumer choice of products and access to professional financial advice"). *See also* 913 Study; Proposing Release at 21575.

Accordingly, rather than requiring mitigation of all firm-level financial incentives, we have determined to refine our approach by generally allowing firm-level conflicts to be generally addressed through disclosure.[740] At the same time, we are persuaded by commenters[741] that there are some conflicts that should be addressed through mitigation at the firm level due to the potential impact that we believe certain conflicts of interest (either at the associated person or firm level) may have on recommendations to retail customers; therefore we are requiring policies and procedures for mitigation or elimination of those conflicts (as identified in the rule text) and are not leaving it to the broker-dealer to determine whether disclosure alone is sufficient.[742] We believe that this approach appropriately balances our goal of reducing the potential harm conflicts of interest may have on broker-dealers' recommendations to retail customers and preserving retail access (in terms of choice and cost) to brokerage products and services.

i. Guidance on Covered Incentives

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740 As discussed above in the section about the Disclosure Obligation, the Commission believes that compliance with the Disclosure Obligation, including disclosure of the material facts relating to the scope and terms of the relationship with the retail customer and all conflicts of interest, should give sufficient information to enable a retail customer to make an informed decision with regard to the recommendation. *See* II.D.1.

Nevertheless, as noted, there may be situations in which disclosure alone may not be sufficient to provide "full and fair" disclosure in accordance with the Disclosure Obligation discussed above, and the broker-dealer may need to take additional steps to mitigate or eliminate the conflict, consistent with an investment adviser's fiduciary duty. *See* Section II.C.3.d.

741 *See, e.g.*, CFA August 2018 Letter.

742 *See* Section II.C.3.f and g.

The Commission interprets this requirement to establish, maintain, and enforce reasonably designed policies and procedures to identify and mitigate any conflicts of interest that create an incentive for the associated person to place the interest of the broker-dealer or such associated person ahead of the interest of the retail customer, to only apply to incentives *provided to* the associated person, whether by the firm or third-parties that are within the control of or associated with the broker-dealer's business.[743] It would not cover external interests of the associated person not within the control of or associated with the broker-dealer's business.[744] In the case of a dually registered individual, this requirement would generally only apply to incentives provided to the associated person when making a recommendation in a brokerage

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743 The ability to control the compensation of associated person, including incentives, is an important mechanism by which broker-dealers exercise supervisory control over sales practices.

744 For example, if an associated person of a broker-dealer participates in a securities transaction outside of the broker-dealer and receives compensation, although the broker-dealer would need to approve the transactions and record it in its books and records under FINRA Rule 3280 (Private Securities Transaction of an Associated Person), as described in more detail above, this requirement to mitigate certain incentives to an associated person would not apply to compensation that is not an incentive provided by or in the control of the broker-dealer.

Nevertheless, additional registration, disclosure or other obligations, and antifraud liabilities may apply to any other firm through which an associated person may have such external interests under federal or state law (for example, as a state-registered adviser). We also note that an associated person of a broker-dealer who receives transaction-based compensation and participates in a private securities transactions that is not in accordance with FINRA Rule 3280 should be mindful of the broker-dealer registration requirements under Section 15 of the Exchange Act.

capacity and not when making a recommendation in an investment advisory capacity as the investment adviser fiduciary duty would apply to the advice given in that instance.[745]

The Commission generally considers the following as examples of incentives to an associated person that would need to be addressed under this revised provision: (i) compensation from the broker-dealer or from third-parties, including fees and other charges for the services provided and products sold; (ii) employee compensation or employment incentives (e.g., incentives tied to asset accumulation and not prohibited under (a)(2)(iii)(D), as discussed below, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); and (iii) commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer, the broker-dealer or a third-party. These examples focus on compensation that varies based on the advice given, such as commissions, markups/markdowns, loads, revenue sharing, and Rule 12b-1 fees.

ii. Guidance on Mitigation Methods

By requiring that a broker-dealer establish policies and procedures reasonably designed to "mitigate" these conflicts of interest, we mean the policies and procedures must be reasonably designed to reduce the potential effect such conflicts may have on a recommendation given to a retail customer. Thus, whether or not a broker-dealer's policies and procedures are reasonably

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745 *See* Fiduciary Interpretation; Section II.B.3.

designed to mitigate such conflicts will be based on whether they are reasonably designed to reduce the incentive for the associated person to make a recommendation that places the associated person's or firm's interests ahead of the retail customer's interest.

As noted in the Proposing Release, in lieu of mandating specific mitigation measures or a "one-size fits all" approach, we are providing broker-dealers with flexibility to develop and tailor reasonably designed policies and procedures that include conflict mitigation measures, based on each firm's circumstances.[746] Reasonably designed policies and procedures should include mitigation measures that depend on the nature and significance of the incentives provided to the associated person and a variety of factors related to a broker-dealer's business model (such as the size of the broker-dealer, retail customer base (e.g., diversity of investment experience and financial needs), and the complexity of the security or investment strategy involving securities that is being recommended), some of which may be weighed more heavily than others. For example, more stringent mitigation measures may be appropriate in situations where the characteristics of the retail customer base in general displays less understanding of the

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746 *See* Proposing Release at 21618. *See also* Letter from Steven W. Stone, Morgan, Lewis & Bockius LLP (May 3, 2019) ("Morgan Lewis Letter") ("The Commission should recognize that firms may appropriately employ only some—or various combinations—of these approaches depending on their businesses and business models, compensation structures, and related conflicts of interest, and should not prescribe a one-size-fits-all approach to mitigating compensation-related conflicts.").

incentives associated with particular securities or investment strategies;[747] where the compensation is less transparent (for example, an incentive from a third-party or charge built into the price of the product or a transaction versus a straight commission); or in a situation involving a complex security or investment strategy.[748] 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 security or investment strategy, or type of incentive across the board; or in some instances a broker-dealer may reasonably determine that some conflicts create incentives that may be more difficult to mitigate, and are more appropriately avoided in their entirety or for certain categories of retail customers.[749]

As noted in the Proposing Release, policies and procedures may be reasonably designed at the outset, but may later cease to be reasonably designed based on subsequent events or information obtained (for example, such as through supervision (e.g., exception testing) of associated person recommendations), and the actual experience of a broker-dealer should be used

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747 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).

748 *See* Proposing Release at 21620-21621.

749 *Id.*

to revise the broker-dealer's measures as appropriate.[750] Further, what are considered reasonable mitigation measures may vary based on the size of the firm.[751] While many broker-dealers have programs currently in place to manage conflicts of interest, each broker-dealer will need to carefully consider whether its existing framework complies with this provision.[752]

In response to commenters' concerns regarding the potential mitigation methods described in the Proposing Release, and, in particular, the references to neutral factors,[753] we would like to emphasize that this non-exhaustive list of factors is purely illustrative and the factors are not required elements.[754] In providing these examples, we did not intend to take a prescriptive approach, as suggested by some commenters, but a principles-based approach

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750 *Id*.

751 In the FINRA Conflicts Report, FINRA identified certain mitigation measures firms implemented that we believe highlight differences in conflict management frameworks, based on the size of the firm. For example, 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.

752 *See* Proposing Release at 21621.

753 *See, e.g.,* Mass Mutual February 2019 Letter; Edward Jones Letter; IRI Letter; Capital Group Letter; SIFMA August 2018 Letter; Committee of Annuity Insurers Letter.

754 *See* Proposing Release at 21621.

designed to provide flexibility to broker-dealers, depending on their business model, level of conflicts, and the retail customers they serve.[755]

Among other things, firms may adopt a range of reasonable alternatives to meet the mitigation requirement of the Conflict of Interest Obligation. As noted above, we recognize that there are a number of different kinds of incentives and that, depending on the specific characteristics of an incentive, different levels and types of mitigation measures may be necessary. For example, incentives tied to asset accumulation generally would present a different risk and require a different level or kind of mitigation, than variable compensation for similar securities, which in turn may present a different level or kind of risk and may require different mitigation methods than differential or variable compensation or financial incentives tied to firm revenues. In certain instances, we believe that compliance with existing supervisory requirements and disclosure may be sufficient, for example, where a firm may develop a surveillance program to monitor sales activity near compensation thresholds.[756]

As discussed above, while not *required* elements, the Commission believes the following non-exhaustive list of practices could be used as potential mitigation methods for firms to comply with (a)(2)(iii)(B) of Regulation Best Interest:

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755 *See* Proposing Release at 21622.

756 FINRA Conflicts Report at 30-31.

- avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- minimizing compensation incentives for employees to favor one type of account over another; or to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis, for example, by establishing differential compensation based on neutral factors;[757]
- eliminating compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across 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,[758] proprietary products or transactions in a principal capacity; or, involve the roll over or transfer of assets from one type of account to

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757 As noted above, we are not requiring firms to establish differential compensation based on neutral factors but do believe firms could choose to do so as potential practice to promote compliance with the requirement to establish, maintain, and enforce written policies and procedures reasonably designed to identify and mitigate any conflicts of interest that create an incentive for an associated person to place its interest ahead of the interest of the retail customer.

758 *See* Morgan Lewis Letter (suggesting, among other things, that firms can conduct surveillance (whether transactions, periodic, or forensic) to identify activity that appears to be driven by compensation considerations—whether at the representative, team, or business level—rather than a customer's interest).

another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA) or from one product class to another;[759]

- adjusting compensation for associated persons who fail to adequately manage conflicts of interest; and
- limiting the types of retail customer to whom a product, transaction or strategy may be recommended.[760]

While the Commission is providing flexibility so that broker-dealers can determine the nature and extent of mitigation, whether a broker-dealer has developed policies and procedures reasonably designed to mitigate a conflict is not measured against industry practice (although such practice could be a useful point of reference). Each firm must look at the facts and circumstances surrounding the mitigation methods, the particular broker-dealer's business model, and whether or not the policies and procedures were reasonably designed for the particular firm to reduce the impact of the incentive in a manner to prevent the incentive from causing the associated person to place the broker-dealer's or the associated person's interest ahead of the retail customer's interest.

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759 *See* FINRA Exam Report 2017. FINRA observed a variety of effective practices in recommending the purchase and sale of UITs, including tailoring supervisory systems to products' features and sources of risk to customers.

760 *See, e.g., supra* footnote 747; FINRA Regulatory Notice 12-03, Heightened Supervision of Complex Products (Jan. 2012).

In response to a commenter's concern that we suggested in the Proposing Release that some compensation conflicts may be more appropriately avoided for certain categories of retail customers,[761] we would like to clarify that such a suggestion is an example and not a requirement. Nevertheless, we are adopting a requirement to establish, maintain, and enforce written policies and procedures reasonably designed to eliminate the incentives that we believe create the most problematic conflicts, namely incentives to associated persons that are tied to recommendations of specific securities or specific types of securities within a limited period of time as we believe these incentives cannot be adequately mitigated, and are likely to result in recommendations that place the interest of the broker-dealer or associated person ahead of the interests of the retail customer. Furthermore, in accordance with the Care Obligation, a broker-dealer, when making a recommendation, is required to, among other things, have a reasonable basis to believe that the recommendation is in the best interest of the particular retail customer.[762] In particular, and consistent with existing suitability obligations, a broker-dealer is required to exercise "reasonable diligence" to ascertain (and consider) the retail customer's investment profile which, among

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761 *See* Primerica Letter ("The SEC's statements in the Proposals regarding the additional protections broker-dealers should afford 'less sophisticated' retail customers could create a sub-class of retail customers that broker-dealers would have to identify based on subjective and poorly defined criteria, and potentially further restrict access to help with saving and investing for customers who need it most.").

762 *See* Section II.C.2.

other things, includes the retail customer's investment experience and risk tolerance.[763] A broker-dealer that has established reasonably designed policies and procedures to mitigate the conflicts associated with the incentives provided to the associated person would nevertheless violate Regulation Best Interest if the recommendation does not comply with the Care Obligation.

Finally, in response to commenters' questions regarding the permissibility of specific practices, the Commission believes the revised, explicit requirements related to: mitigation of incentives to associated persons as discussed herein; mitigation of any material limitations placed on the securities or investment strategies that may be recommended to retail customers; and elimination of certain practices, as discussed below, sufficiently address these comments. To the extent the Commission has not identified a practice that needs to be eliminated, it would be permitted, subject to compliance with the requirements of Regulation Best Interest.

f. Mitigation of Material Limitations on Recommendations to Retail Customers

As part of the proposed requirement to manage conflicts of interest arising from financial incentives through mitigation, firms would have been required to establish policies and procedures reasonably designed to mitigate the conflicts of interest associated with offering a limited range of products and proprietary products.

We also solicited comment on information related to the magnitude of conflicts of interest when broker-dealers recommend, among other things, proprietary products and a limited

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763 *Id*.

range of products. In response, several commenters requested that the Commission confirm that a product menu limited to appropriate alternative investments offered by the broker-dealer would not violate Regulation Best Interest.[764] Some commenters requested we clarify that, for certain customers, a firm can limit its offerings to proprietary products or products for which the firm receives revenue sharing payments if the limitation is properly disclosed and appropriate to meet the retail customer's needs.[765]

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764 *See, e.g.*, SIFMA August 2018 Letter (requesting clarification on how a broker-dealer could satisfy the Conflict of Interest Obligation if the platform is limited to certain bond offerings); Fidelity Letter (stating that given the vast array of readily available investment options and the breadth of securities typically available to customers through broker-dealers, some limitation of the universe of investment options must be undertaken in order for a broker-dealer to adequately understand, compare and formulate a recommendation); Prudential Letter ("It is unclear what 'significantly limits' means for firms that offer predominantly, but not exclusively, proprietary products. It is also unclear what constitutes a 'small choice of investments.' Additional examples or more prescriptive instructions regarding when firms must disclose such limitations would be helpful."). *See also* Guardian August 2018 Letter; LPL August 2018 Letter; LPL December 2018 Letter.

765 *See, e.g.*, SIFMA August 2018 letter; CFA Institute Letter; Letter from Emanuel Alves, Senior Vice President and General Counsel, John Hancock Life Insurance Company (Aug. 3, 2018) ("John Hancock Letter"); Ameriprise Letter. *See also* NY Life Letter (recommending the Commission require disclosure of the limits on the universe of available products, while allowing further context so that firms describe the full scope and impact of those limits); SPARK Letter (recognizing that the SEC did not want to mandate specific mitigation procedures or a "one-size-fits" all" approach but requesting further guidance in the case of, among other things, broker-dealers who only offer proprietary products or only offer limited investment menus). *But see* CFA August 2018 Letter (suggesting that simply stating that a firm offers a limited selection of investments may not be enough for an investor to understand the limitations).

In consideration of these comments, and our revisions to remove firm-level conflicts from the proposed mitigation provision discussed above, we are adopting a new requirement to specifically address the conflicts of interest presented when broker-dealers place any material limitations on the securities or investment strategies that may be recommended to a retail customer (i.e., only make recommendations of proprietary or other limited ranges of products). While we generally believe that most firm-level conflicts of interest can be addressed through appropriate disclosure, this new provision focuses on the specific firm-level conflicts—namely, the conflicts associated with the establishment of a product menu—which we believe are most likely to affect recommendations made to retail customers and have the greatest potential to result in recommendations that place the interest of the broker-dealer or associated person ahead of the interest of the retail customer.[766] Given the potential impact on recommendations to retail customer, we believe these conflicts should not be left to the broker-dealer to determine whether disclosure alone is sufficient, and are requiring broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to (1) identify and disclose any material limitations broker-dealers place on their securities offerings or investment strategies involving

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[766] *See* CFA August 2018 Letter ("[M]any broker-dealers currently restrict choice by only recommending from a limited menu of proprietary funds or by only recommending products from companies that make revenue sharing payments. If limits on investor choice are of concern to the Commission, surely such limits deserve equal scrutiny. After all, evidence suggests that the limited menus offered by some firms consist entirely of low quality products that impose excessive costs, deliver inferior returns, and expose investors to excessive risk.")

securities and any associated conflicts of interest and (2) prevent such limitations and associated conflicts of interest from causing the broker-dealer to make recommendations that place the broker-dealer's interest ahead of the interest of the retail customer.

While we believe broker-dealers should be permitted to limit their product offerings from which they make recommendations to retail customers, provided that they comply with Regulation Best Interest,[767] we are also concerned that without requiring a broker-dealer to have a process in place to disclose and address negative effects of such limitations, retail customers may be unaware that a broker-dealer offers only a limited set of products and therefore would be unable to make an informed investment decision.[768] We are also concerned that retail customers may be harmed by such limitations if they are more likely to result in recommendations that are not in the best interest of the retail customer.[769]

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767 *See* Section II.C.2 for a related discussion of the application of the Care Obligation to such limitations. *See also* AFL-CIO April 2019 Letter (recommending that the Commission make clear that it will hold firms accountable for developing a product menu that complies with the first prong of the proposed best interest standard and that under such approach, firms would periodically assess their product offerings against other products available in the marketplace in order to ensure that their offerings are competitive).

768 *See* Disclosure Obligation at Section II.C.1.

769 We believe that by including this requirement to address material limitations to product menus, which does not rely on disclosure alone, coupled with the requirements under the Care Obligation, we are addressing a commenter's concern that product limitations can limit investor choice which in turn harms investors. *See* CFA August 2018 Letter.

Broker-dealers will be required to establish, maintain and enforce written policies and procedures reasonably designed to: (i) 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 the Disclosure Obligation, and (ii) 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.

As discussed in the context of the Disclosure Obligation and the Relationship Summary, for purposes of this requirement, a "material limitation"[770] placed on the securities or investment strategies involving securities would include, for example, recommending only proprietary products (i.e., any product that is managed, issued, or sponsored by the financial institution or any of its affiliates), a specific asset class, or products with third-party arrangements (i.e., revenue sharing).[771] In addition, the fact that the broker-dealer recommends only products from a select group of issuers could also be a material limitation.

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770 As discussed in Section II.C.1, Disclosure Obligation, a limitation is "material" if there is "a substantial likelihood that a reasonable shareholder would consider it important." *Basic, Inc. v. Levinson*, 485 U.S. 224, 224 (1988). In the context of this Regulation Best Interest, this standard would apply in the context of retail customers, as defined.

771 *See* II.C.1.; Relationship Summary Adopting Release.

We recognize, however, that, as a practical matter, almost all broker-dealers limit their offerings of securities and investment strategies to some degree. We do not believe that disclosing the fact that a broker-dealer does not offer the *entire* possible range of securities and investment strategies would convey useful information to a retail customer, and therefore we would not consider this fact, standing alone, to constitute a material limitation.[772] Rather, consistent with the examples of a "material limitation" provided above, whether the limitation is material will depend on the facts and circumstances of the extent of the limitation.

Adopting this revised requirement is critical to ensuring that retail customers are aware of any material limitations associated with a broker-dealer's recommendation and associated conflicts of interest and that broker-dealers, through their policies and procedures, establish processes to evaluate whether or not such a limited range of products is consistent with making recommendations that are in the retail customer's best interest and that do not place the interests of the broker-dealer or associated person ahead of the retail customer's interest, consistent with Care Obligation.[773] Broker-dealers would be able to satisfy paragraph (a)(2)(iii)(C)(i) by identifying any material limitations and complying with the Disclosure Obligation which, as discussed above, requires disclosure of "the type and scope of services provided to the retail

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772 *See Basic, Inc. v. Levinson*, 485 U.S. 224, 224 (1988).

773 *See* Section II.C.2 and *infra* footnote 779.

customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer."[774]

Similar to the requirement to establish, maintain, and enforce written policies and procedures reasonably designed to mitigate certain incentives to associated persons, firms will have flexibility to develop and tailor reasonably designed policies and procedures to prevent such limitations and the associated conflicts from causing the broker-dealer or associated person from placing their interest ahead of the retail customer's interest. In developing such policies and procedures, the Commission believes that firms should, for example, consider establishing product review processes for products that may be recommended, including establishing procedures for identifying and mitigating the conflicts of interests associated with the product, or declining to recommend a product where the firm cannot effectively mitigate the conflict, and identifying which retail customers would qualify for recommendations from this product menu.[775] As part of this process, firms may consider evaluating the use of "preferred lists," [776]

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774 Section II.C.1.

775 For example, in its Conflicts Report, FINRA identified the following as effective practices to identify and manage conflicts of interest for new products: (i) a product review process to identify and mitigate conflicts of interest that may be associated with a product; (ii) evaluation of whether to decline to offer products to customers when the conflicts associated are too significant to be mitigated effectively; (iii) differentiation of product eligibility between institutional and retail clients; (iv) post-launch reviews of products to identify potential problems; (v) evaluation of registered representatives' ability to understand a product, provide training where necessary, and limit access to products for which they cannot demonstrate sufficient understanding to perform a

restricting the retail customers to whom a product may be sold, prescribing minimum knowledge requirements for associated persons who may recommend certain products,[777] and conducting periodic product reviews to identify potential conflicts of interest, whether the measures addressing conflicts are working as intended, and to modify the mitigation measures or product selection accordingly.[778] The Commission's intent is not to prevent firms from offering proprietary products or other limited range of products so long as firms comply with the Disclosure, Care,[779] and Conflict of Interest Obligations. In fact, we believe that these limitations can be beneficial, such as by helping ensure that a broker-dealer and its associated

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suitability analysis and effectively explain a product and its risks to customers; and (vi) disclosure of product conflicts and risks. *See* FINRA Conflicts Report at 3, 18-25.

776 *See* FINRA Conflicts Report at 24.

777 *Cf.* FINRA Conflicts Report at 19 (stating that as an effective practice in evaluating new products, a product review committee may engage in these activities to address conflicts of interest).

778 *Cf., e.g.*, NASD Notice to Members 03-71, Non-Conventional Investments – NASD Reminds Members of Obligations When Selling Non-Conventional Investments (Nov. 2003). Similarly, under the Compliance Obligation, we suggest that compliance policies and procedures' adequacy and effectiveness should be reviewed as frequently as necessary in connection with changes in business activities, affiliations, or regulatory and legislative developments. *See* Section II.D.4, Compliance Obligation.

779 In particular, consistent with the Care Obligation and as discussed further in Section II.C.2, Care Obligation, as part of determining whether a broker-dealer has a reasonable basis to believe that a recommendation is in the best interest of the retail customer, broker-dealers generally need to evaluate reasonably available alternatives offered by the broker-dealer. When a broker-dealer materially limits is product offerings or offers only a limited menu of products, it must still comply with the Care Obligation, and could not use its limited menu to justify recommending a product that does not satisfy this obligation. *See* Section II.C.2.

persons understand the securities they are recommending, as required by the Care Obligation.[780] This requirement is designed to allow firms to determine whether and how to restrict their menu of investment options based, among other things, on their retail customer base and area of expertise, while protecting the interests of retail customers when recommendations are made from such limited menus by requiring firms have a reasonably designed process to identify, disclose, and prevent the conflicts of interest associated with such limitations from resulting in recommendations that place the broker-dealer's interests ahead of the retail customer's interest.

We also note that the risk that limited product menus result in recommendations that are not in the retail customer's best interest is also addressed through the Care Obligation[781] and required disclosure pursuant to the Disclosure Obligation.[782]

g. Elimination of Certain Conflicts of Interest

Under Section 15(l)(2) of the Exchange Act, the Commission may examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the

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780 *See also supra* footnote 775.

781 *See id*.

782 Material limitations are material facts that need to be disclosed pursuant to the Disclosure Obligation. The Commission is concerned about the potential effect that such limitations have on the securities or investment strategies involving securities recommended to a retail customer, and any associated conflicts of interest, could have on the ability of a broker-dealer to make a recommendation in the best interest of the retail customer. *See* Disclosure Obligation at Section II.C.1.

Commission deems contrary to the public interest and protection of investors. As discussed below, the Commission finds that it is in the public interest and consistent with the protection of investors to require that broker-dealers establish, maintain, and enforce written policies and procedures reasonably designed to 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.

In the Proposing Release, the Conflict of Interest Obligation would have required the establishment of 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). We did not mandate the absolute elimination of, or policies and procedures reasonably designed to eliminate any particular conflicts.[783] We were concerned that the absolute elimination of specified particular conflicts could mean a broker-dealer may not receive compensation for its services.[784] Our intent, rather, was to identify certain practices that may be more appropriately

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783 *See* Proposing Release at 21619.

784 *Id.*

avoided for certain categories of retail customers, including, for example, sales contests, trips, prizes, and other similar bonuses based on sales of certain securities or accumulation of AUM.[785]

We also provided examples of how a broker-dealer could eliminate conflicts of interest.[786] We requested comment on elimination, including suggestions of whether certain conflicts should be required to be eliminated and how broker-dealers could eliminate conflicts of interest. Specifically, we requested comment on whether the Commission should explicitly prohibit receipt of certain non-cash compensation (e.g. sales contests, trips, prizes, and other bonuses based on sales of certain securities, accumulation of AUM or any other factor).[787]

In response, several commenters requested greater certainty as to whether certain conflicts of interest should be eliminated and if so, which ones.[788] Some commenters generally

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785 *See id*. FINRA rules also establish restrictions on the use of non-cash compensation in connection with the sale and distribution of certain types of products. *See* FINRA Rules 2310, 2320, 3221, and 5110.

786 Proposing Release at 21621-21622.

787 *Id*.

788 *See* TIAA Letter ("If the SEC were to provide more specific direction as to which conflicts are significant enough to warrant complete elimination, broker-dealers would be better able to effectively address material conflicts of interest in a manner consistent with the SEC's goals and preferred approach."); Wells Fargo Letter ("Rather than leaving broker-dealers vulnerable to second-guessing, the SEC should either provide more guidance on how such conflicts may be mitigated or simply identify a set of financial incentives that are prohibited."); AXA Letter ("In the absence of clear guidance from the Commission as to which financial incentives must be eliminated, and not just mitigated and disclosed, broker-dealers may be forced to curtail otherwise legitimate practices and the sale of certain products and services out of an abundance of caution—thereby

requested that certain sales contests and financial incentives be prohibited.[789] Of these commenters, many expressed concern that product-based incentives could lead to recommendations that are not in a customer's best interest, with some commenters stating that firms could find ways to mitigate these conflicts[790] and others advocating that they should be

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depriving investors of choice of offerings for which they might otherwise be suited… It would also be helpful if the Commission could provide additional examples of the types of conflicts (besides "sales contests, trips, prizes . . . based on sales of certain securities") that likely require elimination."); *see also* Money Management Institute Letter; Northwestern Mutual Letter; AALU Letter.

789 *See, e.g.,* PIABA Letter (favoring a prohibition on compensation structures that would incentivize a broker to: recommend a proprietary product or recommend one type of product line over another; and/or which would reward the sale of certain products within a product line"), Americans for Financial Reform (recommending prohibiting brokers from adopting practices, such as sales quotas and contests, that clearly incentivize their representatives to base their recommendations on their own financial interests rather than the customer's best interests); NASAA August 2018 Letter ("[W]e encourage the Commission to proceed further by declaring these two practices − sales contests and preferential treatment of allocations − *per se* impermissible under Regulation Best Interest."); Galvin Letter (identifying the following practices as per se violations of the standard as they are contrary to the requirement to provide advice that is in the true best interest of customers: sales contests; sales quotas (especially for in-house products); and incentives to sell high-cost and high-risk products); *See also* Warren Letter; Better Markets August 2018 Letter; CFA August 2018 Letter. *But see* Primerica Letter ("The SEC should recognize that sales contests, trips, prizes, awards, and similar bonuses can be used to incentivize positive behavior and clarify there is no per se requirement to eliminate such incentives.").

790 *See, e.g.,* SIFMA August 2018 Letter ("With respect to product-based sales contests, we agree that instances where a firm cannot adequately mitigate incentives that are misaligned with the customer's best interest, the firm should eliminate such sales contests. A firm, however, may be able to mitigate such conflicts through several methods…under a principles-based regime, we ask that the SEC allow firms to decide whether to mitigate or eliminate such conflicts."); Cetera August 2018 Letter ("A commonly-cited example is

prohibited in their entirety.[791] Other commenters requested clarification that incentives not tied to a particular investment product would be permitted and would not need to be eliminated.[792] A number of commenters requested clarification that incentives based on asset growth would be

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sales contests or incentives that are focused on sales of a single product. While we agree that such arrangements may be *per se* inappropriate and Cetera does not permit them, this judgment is largely subjective. We suggest that reaching consensus on what other practices fall into this category would be well-nigh impossible. So long as a broker-dealer can demonstrate that it has made a good faith determination regarding identification and management of conflicts, it should not be subject to either regulatory action or private litigation based on those determinations."); CFA Institute Letter ("Our view is that recommendations aimed at winning sales contests and meeting internal quotas are irreconcilable with the concept of a best interest standard and should not be allowed.").

791 *See, e.g.,* PIABA Letter; CFA August 2018 Letter. *See also* Fidelity Letter ("The SEC has properly pointed out that certain conflicts of interest can be so problematic that it simply may not be possible to mitigate them effectively. For example, we agree that sales contests improperly favoring certain investment products over others involve uniquely troubling conflicts and should generally be impermissible."); NY Life Letter (In this context, the proposal notes that single product sales contests create conflicts that may best be eliminated. We agree that it is inappropriate to use a contest or other non-cash compensation to incentivize the sale of a specific investment or variable insurance product over other available alternatives, irrespective of a consumer's situation and needs.") *But see* AALU Letter (finding that the Commission should not prohibit currently-compliant compensation arrangements and business models, including non-cash compensation).

792 *See, e.g.,* SIFMA August 2018 Letter; Edward Jones Letter; NY Life Letter; Prudential Letter; LPL August 2018 Letter; Transamerica August 2018 Letter; Northwestern Mutual Letter; Letter from Eric R. Dinallo, Executive Vice President, General Counsel, Guardian Life (Feb. 6, 2019) ("Guardian February 2019 Letter") ; Primerica Letter; Cambridge Letter. Some of these commenters stated that FINRA's rules and supervisory practices appropriately cover these incentives. *See* Transamerica August 2018 Letter; NY Life Letter; Northwestern Mutual Letter; Guardian August 2018 Letter; Primerica Letter.

permitted as they do not raise the same types of conflicts present with product-based sales.[793] A number of commenters expressed concern that provisions requiring elimination of certain conflicts could be in conflict with current treatment under the Internal Revenue Code governing certain employee benefits.[794]

After considering comments, we are modifying the rule text of the Conflict of Interest Obligation to include new paragraph (a)(2)(iii)(D), which requires the broker or dealer to establish, maintain, and enforce written policies and procedures reasonably designed to 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. In adopting this new requirement, the Commission believes it will provide certainty to broker-dealers regarding the types of practices where conflicts of interest are so pervasive such that they cannot be reasonably mitigated and must be eliminated in their entirety, as we believe they create too strong of an incentive for the associated persons to make a recommendation that

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793 Generally these commenters believed that programs tied to assets under management, total production or revenue growth do not give associated persons an incentive to recommend specific securities that may be inconsistent with a customer's best interest. *See, e.g.,* SIFMA August 2018 Letter; Bank of America Letter; Edward Jones Letter; Transamerica August 2018 Letter; ASA Letter; UBS Letter; Fidelity Letter; NY Life Letter; Money Management Institute Letter; IPA Letter.

794 *See* AALU Letter; NY Life Letter; Guardian February 2019 Letter; Northwestern Mutual Letter.

places their financial or other interest ahead of the interest of retail customers' interests and therefore would be inconsistent with Regulation Best Interest.[795]

The requirement is designed to eliminate sales contests, sales quotas, bonuses and non-cash compensation that are based on the sales of specific securities and specific types of securities within a limited period of time. We believe that these practices, particularly when coupled with a time limitation, create high-pressure situations for associated persons to engage in sales conduct contrary to the best interest of retail customers. For purposes of this requirement, we interpret non-cash compensation to mean any form of compensation received in connection with the sale and distribution of specific securities or specific types of securities that is not cash compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals and lodging except we do not intend it to cover certain employee benefits, including healthcare and retirement benefits.[796] We recognize that some associated persons may focus their business on certain general categories of securities (e.g., mutual funds, variable annuities, bonds, or equities) and that broker-dealers may provide compensation or other incentives related to such sales. As discussed further herein, this requirement is not designed to prohibit broker-dealers

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795 *See* Section I. *See also* AFL-CIO April 2019 Letter ("The Commission must provide greater clarity regarding how the obligation to eliminate or mitigate conflicts would apply to different types of conflicts. In particular, it must make clear that conflicts cannot be addressed through disclosure alone and that firms would be prohibited from artificially creating harmful incentives that undermine compliance with the best interest standard.").

796 *Infra* footnote 803 and accompanying text.

from providing such incentives, provided that they do not create high-pressure situations to sell a specifically identified type of security (e.g., stocks of a particular sector or bonds with a specific credit rating) within a limited period of time, such that the associated person cannot make a recommendation in the retail customer's best interest.

We believe the conflicts created by these practices are in direct opposition to our goal of reducing the effect of conflicts of interest on broker-dealer recommendations to retail customers.[797] We agree with many commenters that broker-dealers cannot reasonably be expected to make recommendations in a particular retail customer's best interest consistent with the requirements of the Care Obligation, if they are motivated to "push" certain securities or types of securities in order to win a contest or reach a target in order to receive a bonus or other non-cash compensation. We are also persuaded that it would be difficult, if not impossible, for a firm to establish reasonably designed policies and procedures to sufficiently mitigate the incentive created to put the broker-dealer's interest ahead of the retail customer's interest, as discussed above, as the point of these practices is simply to increase the sale a particular security or type of security, for example, in the context where a broker-dealer is attempting to reduce its inventory of or exposure to that security. Accordingly, we believe that these practices should be

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[797] *See* Section I.

eliminated in order to enhance investor protection[798] and achieve the goals of Regulation Best Interest.

By explicitly requiring broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to eliminate certain practices, we believe we are responding to commenters who requested certainty as to which specific incentives are prohibited.[799] Also in response to commenters requesting clarification as to what practices would be permitted, the requirement to have reasonably designed written policies and procedures to eliminate sales contests, sales quotas, bonuses, and non-cash compensation applies only to those that are based on the sales of specific securities or types of securities, and does not apply to compensation practices based on, for example, total products sold, or asset growth or accumulation,[800] and customer satisfaction. In addition, this elimination requirement would not prevent firms from offering only proprietary products, placing material limitations on the menu of products, or incentivizing the sale of such products through its compensation practices, so long as the

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798 *See* Chairman Jay Clayton, *Statement on Investor Roundtables Regarding Standards of Conduct for Investment Professionals Rulemaking* (Aug. 22, 2018), *available at* https://www.sec.gov/news/public-statement/statement-clayton-082218. *See also* CFA Institute; CFA.

799 *See supra* footnote 788 and accompanying text.

800 *See* CCMC Letters (asserting that increasing assets under management is a natural outgrowth of serving clients well and is fundamentally different from sales contests based on a particular product); UBS Letter (stating that compensation and other rewards based on the growth of overall revenues or assets under management should continue to be permitted as they do not incent sales of one product over another but instead simply reward overall business growth).

incentive is not based on the sale of specific securities or types of securities within a limited period of time.[801] While conflicts of interest are also associated with sales contests, sales quotas, bonuses and non-cash compensation that apply to, among other things, total products sold, or asset accumulation and growth, we agree with commenters[802] these conflicts present less risk that the incentive would compromise compliance with the Care Obligation and Conflict of Interest Obligation such that a recommendation could be made that is in a retail customer's best interest and that does not place the place the interest of the broker-dealer or associated person ahead of the interest of the retail customer.

We also recognize that certain production requirements may exist for other reasons, specifically to maintain a contract of employment.[803] As discussed above, we do not intend to

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801 Although we are not defining what would constitute a "limited period of time," as noted above, we are concerned about time limitations that create high-pressure situations for associated persons to increase the sales of specific securities or specific types of securities which compromise the best interests of their customers.

802 *See, e.g.*, Ameriprise Letter ("We believe such concerns around incentives do not exist with respect to programs that reward asset growth or asset flows, or recruitment bonuses tied to assets under management or revenue growth because these programs do not give associated persons an incentive to recommend specific securities that may not be consistent with a customer's best interest."); Empower Letter ("We also believe asset-gathering or account-retention incentives should not be subject to the same level of scrutiny as incentives aimed at increasing sales of particular securities. The potential for a conflict of interest to result in a bad outcome for a retail investor is much higher when a recommendation is related to individual securities rather than the type of account in which such securities should be held.")

803 *See* Prudential Letter; NY Life Letter; Guardian February 2019 Letter; AALU Letter. Under the Internal Revenue Code, statutory employees are eligible for certain employee

prohibit the receipt of certain employee benefits by statutory employees, and do not believe this provision would apply, as we do not consider these benefits to be non-cash compensation for purposes of Regulation Best Interest. In addition, we do not intend to prohibit training or education meetings, including attendance at company-sponsored meetings such as annual conferences,[804] provided that these meetings are not based on the sale of specific securities or type of securities within a limited time period.

We emphasize that prohibiting certain incentives does not mean that all other incentives are presumptively compliant with Regulation Best Interest. As discussed above, such other incentives and practices that are not explicitly prohibited are permitted provided that the broker-dealer establishes reasonably designed policies and procedures to disclose and mitigate the incentive created, and the broker-dealer and its associated persons comply with the Care Obligation. Nevertheless, if the firm determines that the conflicts associated with these practice are too difficult to disclose and mitigate, the firm should consider carefully assessing whether it is able to satisfy its best interest obligation in light of the identified conflict and in certain circumstances, may wish to avoid such practice entirely.

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benefits such as 401(k) and health insurance. In order to qualify under this definition, full time life insurance sales agents must devote their principal business to the solicitation of life insurance or annuities primarily for one company. *See* Department of Treasury, Internal Revenue Service, Employer's Supplemental Tax Guide, Publication 15-A (2018), *available at* https://www.irs.gov/pub/irs-pdf/p15a.pdf.

804 *See* Guardian August 2018 Letter; NY Life Letter.

4. Compliance Obligation

As proposed, under the Conflict of Interest Obligation, a broker-dealer entity[805] would be required to: (1) establish, maintain, and enforce written policies and procedures reasonably designed to identify, and disclose, or eliminate all material conflicts of interest 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. As discussed above, in response to commenters, we have made modifications to the Conflict of Interest Obligation to more appropriately focus on the conflicts of interest that create an incentive for broker-dealers and their associated persons to place the interest of the broker-dealer or the associated person ahead of the interest of the retail customer.

We solicited comment on the proposed requirement to establish, maintain, and enforce certain policies and procedures as part of the Conflict of Interest Obligation, including whether we should require policies and procedures specifically to assist compliance with Regulation Best Interest. While commenters generally viewed the requirement to adopt policies and procedures as an effective means of addressing conflicts of interest,[806] some commenters suggested broadening this requirement to a general policies and procedures obligation that would be

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805 *See supra* footnote 671.

806 *See* CFA August 2018 Letter; Fidelity Letter; Vanguard Letter; FPC Letter.

reasonably designed to ensure that recommendations are made in the customer's best interest or reasonably designed to ensure compliance with Regulation Best Interest as a whole.[807]

After considering the comments received, we are adopting the Compliance Obligation, which requires, in addition to the policies and procedures required by the Conflict of Interest Obligation, that broker-dealer entities[808] establish, maintain and enforce written policies procedures reasonably designed to achieve compliance with Regulation Best Interest. The Compliance Obligation creates an affirmative obligation under the Exchange Act with respect to the rule as a whole,[809] while providing sufficient flexibility to allow broker-dealers to establish

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807 *See* CFA August 2018 Letter; UBS Letter.

808 Similar to the Conflict of Interest Obligation, the Compliance 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 Compliance Obligation, the term "broker-dealer" refers only to the broker-dealer entity, and not to such individuals. *See* footnote 671 and accompanying text.

809 As noted in the Proposing Release, 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. *See* Proposing Release at 21622. Specifically, the Exchange Act authorizes the Commission to sanction a broker-dealer or any associated person that fails to reasonably supervise another person subject to the firm's or the person's supervision that commits a violation of the federal securities laws. Exchange Act Sections 15(b)(4)(E) and (b)(6)(A). The Exchange Act provides an affirmative defense against a charge of failure to supervise where reasonable procedures and systems for applying the procedures have been established and effectively implemented without reason to believe those procedures and systems are not being complied with. *Id*. While the Compliance Obligation creates an explicit requirement, we believe that broker-dealers would likely establish policies and procedures to comply with Regulation Best Interest

compliance policies and procedures that accommodate a broad range of business models.[810] The Commission believes that the Compliance Obligation is important to help ensure that broker-dealers have strong systems of controls in place to prevent violations of Regulation Best Interest, including the component Disclosure and Care Obligations, in addition to the policies and procedures required pursuant to the Conflict of Interest Obligation, and to protect the interests of retail customers.[811]

As with the policies and procedures requirement included in the Conflict of Interest Obligation, whether policies and procedures are reasonably designed to comply with Regulation

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pursuant to Section 15(b)(4)(E). In order to comply, broker-dealers could adjust their current systems of supervision and compliance, as opposed to creating new systems.

810 This approach is similar to the one taken under rule 206(4)-7 under the Advisers Act which requires policies and procedures reasonably designed to prevent violations of the Advisers Act, which should be tailored to address compliance considerations relevant to the operations of each adviser. *See* Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (Dec. 17, 2003) ("Advisers Act Release 2204"). *See also 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 ("No one standard set of policies and procedures will address the requirements established by the Compliance Rule for all advisers because each adviser is different, has different business relationships and affiliations, and therefore, has different conflicts of interest.").

811 Similar to the discussion included under Section II.C.3.a, we believe that policies and procedures to comply with Regulation Best Interest would allow the Commission to identify and address potential compliance deficiencies or failures (such as inadequate or inaccurate policies and procedures, or failure to follow the policies and procedures) early on, reducing the chance of retail customer harm.

Best Interest will depend on the facts and circumstances of a given situation.[812] As such, the Compliance Obligation does not enumerate specific requirements that broker-dealers must include in their policies and procedures as broker-dealers are too varied in their operations for rules to impose a single set of universally applicable specific required elements. Each broker-dealer when adopting policies and procedures should consider the nature of that firm's operations and how to design such policies and procedures to prevent violations from occurring, detect violations that have occurred, and to correct promptly any violations that have occurred.[813]

A firm's compliance policies and procedures should be reasonably designed to address and be proportionate to the scope, size, and risks associated with the operations of the firm and the types of business in which the firm engages.[814] As such, the Commission is not mandating specific requirements pursuant to the Compliance Obligation. In addition to the required policies and procedures, depending on the size and complexity of the firm, we believe a reasonably designed compliance program generally would also include:[815] controls; remediation of non-compliance;[816] training;[817] and periodic review and testing.[818]

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812 *See* Section II.C.3.

813 *See* Advisers Act Release 2204.

814 *See* Section II.C.3.a.

815 *Cf.* FINRA Conflicts Report at 6 (identifying supporting structures, policies, processes, controls and training as critical to protect customers and the firm).

816 *Id.* at 10 ("Most firms' policies describe an escalation process for handling those conflicts of interest that cannot be handled through other firm policies….").

D. Record-Making and Recordkeeping

In connection with proposed Regulation Best Interest, we proposed new record-making and recordkeeping requirements for broker-dealers with respect to certain information collected from or provided to retail customers. Specifically, we proposed amendments to Exchange Act Rules 17a-3 and 17a-4, which 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. We received several comments on the proposed new requirements and are adopting them substantially as proposed with additional clarifications and guidance to address commenters' concerns.

We proposed amending Rule 17a-3[819] 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,

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817 "For firms, training is an important vehicle to communicate firm culture, specific requirements of a firm's code of conduct and its conflicts management framework." *Id.* at 15.

818 *Cf. 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; FINRA Conflicts Report.

819 *See* Exchange Act Rule 17a-3.

responsible for the account. The new paragraph would specify 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.

We are adopting the provision substantially as proposed but redesignating it as new paragraph (a)(35) of Rule 17a-3.[820] We are also amending the text of paragraph (ii) of the amendment as adopted to refer to "any information described in paragraph (a)(35)(i) of this section" rather than the proposed "any information required under paragraph (a)(25)(i) of this section." This is a non-substantive change reflecting the fact that paragraph (i) of the new provision requires a record of the information collected from a retail customer by the broker-dealer pursuant to Regulation Best Interest; it does not require the information itself directly as implied by the original wording of paragraph (i) of the proposed amendment. It is therefore more accurate to refer in paragraph (ii) to the information "described in," rather than "required under," paragraph (i), as well as to update the reference in paragraph (ii) to "paragraph (a)(35)(i) of this section."

Several commenters expressed concern that the proposed rule amendment would significantly expand recordkeeping requirements.[821] One commenter expressed concern that the record retention requirements of the proposed new paragraph to Rule 17a-3 would apply to each

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820 The Commission is also reserving paragraphs (a)(24) through (a)(34) of Rule 17a-3 for use in connection with future rulemakings.

821 *See* SIFMA August 2018 Letter; Edward Jones Letter; Primerica Letter.

recommendation made by the broker-dealer rather than to each account (as required by existing paragraph (a)(17) of Rule 17a-3, which operates on a per-account basis). Another commenter requested clarification that "the current books and records requirement is sufficient to meet record-keeping requirements to satisfy Reg BI," adding that the Commission should "affirm that Reg BI does not create new record-keeping requirements to prove that an advisor acted in a client's best interest."[822]

The Commission notes that the proposed new requirements of Rule 17a-3 are not designed to create additional, standalone burdens for broker-dealers but instead to provide a means by which they can demonstrate, and Commission examiners can confirm, their compliance with the new substantive requirements of Regulation Best Interest. In response to commenter concerns that the proposed requirements would significantly expand their recordkeeping obligations, we reiterate that, as stated in the Proposing Release, broker-dealers should already be attempting to collect much of the information that would be required under Regulation Best Interest pursuant to the FINRA suitability rule and existing Exchange Act books and records rules. For example, we note that under existing Rule 17a-3(a)(17), broker-dealers that make recommendations for accounts with a natural person as customer or owner are already required to create and periodically update customer account information, although as part of developing a "retail customer's investment profile," Regulation Best Interest may require broker-

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822 *See* Raymond James Letter.

dealers to seek to obtain certain retail customer information that is currently not required by Rule 17a-3(a)(17).[823] In addition, Regulation Best Interest would require broker-dealers to disclose in writing the material facts relating to the scope and terms of their relationship with the retail customer and the material facts relating to conflicts of interest that are associated with the investment recommendations provided to the retail customer. As such, it would not be accurate to state, as suggested by the commenter, that the Commission's current books and records requirements for broker-dealers are sufficient to meet recordkeeping requirements to satisfy Regulation Best Interest. The additional books and records requirements the Commission is adopting today are designed to allow firms to demonstrate compliance with the substantive requirements of Regulation Best Interest.

We further note that the new record-making requirements would not require the duplication of existing records. Rather, if a broker-dealer relied upon previously existing records to demonstrate its compliance with Regulation Best Interest for a given recommendation, it would not be required to create and preserve duplicate copies but instead could create a new record noting which pre-existing documents were provided to the customer, or what customer

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[823] *See* Exchange Act Rule 17a-3(a)(17). As explained in the Proposing Release, 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).

information already being preserved by the broker-dealer was relied upon, to meet the obligations of Regulation Best Interest. However, reliance upon previously existing records would only be permissible so long as such records are preserved—a record noting that a document was relied upon would no longer meet the recordkeeping obligations of Regulation Best Interest if such document was no longer preserved by the broker-dealer.

Commenters also requested that the Commission limit new recordkeeping requirements to customer profile information itself, not the "related and underlying communications."[824] In response to these concerns, the Commission clarifies that new paragraph (a)(35) of Rule 17a-3 as adopted requires a record of all information collected from and provided to the retail customer pursuant to Regulation Best Interest. Regulation Best Interest does not reference, and the Commission does not intend that it require, "related and underlying communications"—rather, it applies only to the information that is actually provided to or obtained from the customer pursuant to Regulation Best Interest. Once again, the purpose of the new record-making provision is to allow broker-dealers to demonstrate their compliance with the substantive requirements of Regulation Best Interest. Complying with those substantive requirements will require broker-dealers to obtain from and provide to customers certain information, and new paragraph (a)(35) of Rule 17a-3 requires a record of such information. In response to comments received requesting clarification as to whether information provided to or obtained from a

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824 *See* SIFMA August 2018 Letter; Morgan Stanley Letter.

customer orally would be covered by the new record-making requirements,[825] the Commission clarifies that the requirements of new paragraph (a)(35) of Rule 17a-3 apply to all information collected from or provided to a retail customer pursuant to Regulation Best Interest, whether provided orally or in writing (electronically or otherwise).[826]

Several commenters requested clarification that, except with respect to the specific recordkeeping requirements in the rule text, Regulation Best Interest does not require additional records (e.g., records to evidence best interest determinations on a recommendation-by-recommendation basis).[827] One commenter also stated that, as drafted, there are significant obstacles and costs, including increased privacy and cybersecurity risks, that would result from implementing the proposed new rule, in particular with respect to the "all information collected from….the retail customer" requirement.[828]

In response, the Commission clarifies that while the substantive requirements of Regulation Best Interest apply on a recommendation-by-recommendation basis, consistent with our approach elsewhere, we are not requiring that broker-dealers create and maintain records to

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825 *See* SIFMA August 2018 Letter; Primerica Letter.

826 In the case of information provided orally under the circumstances outlined in Section II.C.1, Disclosure Obligation, *Oral Disclosure or Disclosure After a Recommendation*, the broker-dealer must maintain a record of the fact that oral disclosure was provided to the retail customer.

827 *See* SIFMA August 2018 Letter; Edward Jones Letter; Morgan Stanley Letter; CCMC Letters.

828 *See* Primerica Letter.

evidence best interest determinations on a recommendation-by-recommendation basis. Nor have we determined to require broker-dealers to *provide* information to retail customers relating to the basis for each particular recommendation (i.e., disclose such information), and thus did not envision this information to come within the scope of Rule 17(a)(35).

Rather, in order to demonstrate compliance with Regulation Best Interest, a broker-dealer must be able to demonstrate that it had a reasonable basis to believe that each particular recommendation made to a retail customer was in the best interest of the customer at the time of the recommendation based on the customer's investment profile and the potential risks, rewards, and costs associated with the recommendation. As noted above, the Commission does not intend this to require, in practice, the creation of extensive new and potentially duplicative records for each and every recommendation to a retail customer. Instead, broker-dealers should be able to explain in broad terms the process by which the firm determines what recommendations are in its customers' best interests, and similarly to explain how that process was applied to any particular recommendation to a retail customer. However, we are not mandating that broker-dealers create and maintain a record of each such determination. Nonetheless, as noted above we are providing guidance suggesting that firms may wish to adequately document an evaluation of a recommendation and the basis for that recommendation in particular contexts, such as the

recommendation of a complex product, or where a recommendation may seem inconsistent with a retail customer's investment objectives on its face.[829]

In addition, in response to requests from commenters for confirmation that the proposed record-making requirements do not contemplate broker-dealers needing to create and maintain records of why certain products were recommended over others on a recommendation-by-recommendation basis,[830] we confirm that broker-dealers are not expected to maintain records comparing potential investments to one another so long as they are able to demonstrate that each individual recommendation actually made to a customer meets the requirements of Regulation Best Interest on its own. Regulation Best Interest applies to recommendations *made* to a retail customer, rather than to potential recommendations considered by the broker-dealer but not actually made to the customer.

In response to the commenter's privacy and cybersecurity concerns with respect to the proposed requirement to make a record of all information collected from the customer pursuant to Regulation Best Interest, as noted in the Proposing Release[831] and Section II.C above, although a broker-dealer's customer *obligations* under Regulation Best Interest (e.g., the Care Obligation) go beyond those set forth in the FINRA's suitability rule, the concept of the

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829 *See supra* footnote 610 and accompanying text.

830 *See* SIFMA August 2018 Letter; CCMC Letters.

831 Proposing Release at 21611 (noting that Retail Customer Investment Profile is consistent with FINRA Rule 2111(a) (Suitability)).

"customer's investment profile" that a broker-dealer would be required to compile—that is, the customer *information* it would be required to obtain—pursuant to Regulation Best Interest is consistent with that under FINRA's suitability rule. As such, we believe that since broker-dealers are already required to seek to obtain identical types of retail customer information pursuant to the FINRA suitability rule, broker-dealers should already have in place policies and procedures, including training programs, to address such privacy and cybersecurity concerns.

We also proposed an amendment to paragraph (e)(5) of Rule 17a-4, which currently requires broker-dealers to maintain and preserve in an easily accessible place all account information required by paragraph (a)(17) of Rule 17a-3 for 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.[832] The proposed amendment would 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 the proposed amendment to Rule 17a-3 being adopted today as Rule 17a-3(a)(35), 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 records of the information collected from or provided to each retail customer pursuant to Regulation Best Interest for 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. The Commission is adopting this amendment to Rule 17a-4(e)(5)

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832 *See* Exchange Act Rule 17a-4(e)(5).

substantially as proposed, with the proposed reference to paragraph (a)(25) of Rule 17a-3 replaced with a reference to paragraph (a)(35) to reflect the redesignation of the latter new rule provision as discussed above.

The Commission received several comments regarding the proposed amendment to Rule 17a-4 requesting clarification as to what communications would be required to be retained pursuant to the proposed rule amendment beyond those already required to be retained by existing paragraph (b)(4) of Rule 17a-4.[833] Rule 17a-4(b)(4) requires broker-dealers to retain originals of all communications received and copies of all communications sent by the broker-dealer relating to its business as such for a period of not less than three years, the first two in an easily accessible place.

In response, the Commission notes that while the records that a broker-dealer would be required to make in connection with Regulation Best Interest under new paragraph (a)(35) of Rule 17a-3 may be "business as such" records, the Commission believes it is important, including for examination purposes, that broker-dealers separately retain records that specifically demonstrate compliance with Regulation Best Interest and new paragraph (a)(35) of Rule 17a-3 rather than simply including them in the much broader "business as such" category required to be retained under Rule 17a-4(b)(4). Rule 17a-3(e)(5) currently serves the purpose of allowing broker-dealers to demonstrate compliance with the customer information records required to be

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[833] *See* Exchange Act Rule 17a-4(b)(4); SIFMA August 2018 Letter; Edward Jones Letter; Prudential Letter.

made pursuant to Rule 17a-3(a)(17), and the amendment to Rule 17a-3(e)(5) being adopted today will serve the same purpose with respect to records required to be retained by broker-dealers to demonstrate compliance with Regulation Best Interest and new paragraph (a)(35) of Rule 17a-3.

Finally, as noted in the Proposing Release, the written policies and procedures that broker-dealers will be required to create pursuant to Regulation Best Interest are already currently required to be retained pursuant to Exchange Act Rule 17a-4(e)(7),[834] 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. As such, we did not propose, and are not adopting, any additional recordkeeping requirements with respect to the written policies and procedures that broker-dealers will be required to create pursuant to Regulation Best Interest.

E. Compliance Date

We are providing a compliance date of June 30, 2020, consistent with the transition provisions described in the Relationship Summary Adopting Release.[835] In light of the importance of the protections provided by Regulation Best Interest, we believe that this

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834 *See* Exchange Act Rule 17a-4(e)(7).

835 *See* Relationship Summary Adopting Release.

compliance date will provide adequate notice and opportunity for broker-dealers to comply with Regulation Best Interest, including by creating or updating the necessary disclosures and to developing, updating or establishing their policies and procedures and systems, as appropriate, to achieve compliance with Regulation Best Interest. On and after the Compliance Date, broker-dealers that provide recommendations of securities transactions or investment strategies that register with the Commission would be required to comply with Regulation Best Interest as of the date of registration.

While most commenters requested an implementation period of 18-24 months,[836] one commenter requested an implementation period of 12-18 months.[837] We believe the operational capability needed to develop processes to comply with Regulation Best Interest is sufficiently established by firms of all sizes and resources. While we understand commenters' requests for periods longer than 12 months after effectiveness, the Commission has determined, in light of the importance of the protections afforded by Regulation Best Interest to retail customers, that a Compliance Date of one year after effectiveness is an appropriate timeframe for firms to conduct

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836 *See* Cetera August 2018 Letter; SIFMA August 2018 Letter; HD Vest Letter (recommending that the Commission adopt a 24-month implementation period); Northwestern Mutual Letter; IRI Letter (recommending that the Commission adopt an 18-to-24-month implementation period); CCMC Letters; AXA Letter (recommending that the Commission adopt at least an 18-month implementation period); ACLI Letter; TIAA Letter (recommending that the Commission adopt an 18-month implementation period).

837 *See* Raymond James Letter (recommending that the Commission adopt a 12-18-month implementation period).

the requisite operational changes to their systems to establish internal processes to comply with Regulation Best Interest.[838]

The Commission also believes that it is important to coordinate the transition dates of the Relationship Summary requirements with those of Regulation Best Interest to ensure that all retail investors receive the full suite of protections and benefits afforded by the amended and new rules. Finally, the Commission staff intends to offer firms significant assistance and support during the transition period and thereafter with the aim of helping to ensure that the investor protections and other benefits of the final rule are implemented in an efficient and effective manner.

III. ECONOMIC ANALYSIS

A. Introduction and Primary Goals of the Regulation, Comments on Market Failure and Quantification, and Broad Economic Considerations

1. Introduction and Primary Goals of the Regulation

Regulation Best Interest enhances the broker-dealer standard of conduct beyond existing suitability obligations and aligns the standard of conduct with retail customers' reasonable expectations.

Under Regulation Best Interest, broker-dealers and their associated persons will be required 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 an associated person

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838 *See* footnote 809 and accompanying text.

making the recommendation ahead of the interests of the retail customer. They also will be required to address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest, and in instances where the Commission has determined that disclosure is insufficient to reasonably address the conflict, to mitigate or, in certain instances, eliminate the conflict. As a result, Regulation Best Interest should enhance the efficiency[839] of recommendations that broker-dealers provide to retail customers, allow retail customers to better evaluate the recommendations received, improve retail customer protection when receiving recommendations from broker-dealers, and, ultimately, reduce agency costs[840] and other costs. Importantly, Regulation Best Interest is designed to preserve, to the extent possible, (1) access and choice for investors who may prefer the transaction-based model that broker-dealers generally provide, or the fee-based model that investment advisers generally provide, or a combination of both types of arrangements, and (2) retail customer choice of the level and types of services provided and the securities available. For example, retail customers who intend to buy and hold a long-term investment on a non-discretionary basis may find that paying a one-time commission to a broker-dealer who recommends such an investment is more cost effective than paying an ongoing advisory fee to an investment adviser merely to hold the same

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839 *See infra* footnote 846 and accompanying text.

840 *See infra* footnote 855 and accompanying text.

investment.[841] Retail customers who would prefer advisory accounts but have not yet accumulated sufficient assets to qualify for investment advisory accounts, which may require customers to have a minimum amount of assets, may similarly benefit from recommendations from broker-dealers. Other retail customers who hold a variety of investments, or prefer different levels of services from financial professionals, may benefit from having access to both brokerage and advisory accounts.

The Commission is mindful of the costs imposed by, and the benefits obtained from our rules. Whenever the Commission engages in rulemaking under the Exchange Act 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 also requires the Commission to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.[842] Also, when making rules pursuant to the Exchange Act, S the Commission is required under Section 23(a)(2) to consider, among other matters, the impact any rule would have on competition and is prohibited from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[843] The following analysis considers, in detail, the economic effects that the Commission believes are likely to or may result from Regulation Best Interest. The analysis includes consideration of

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841 *See infra* footnote 1354 and accompanying text.

842 *See* 15 U.S.C. 77b(b) and 15 U.S.C. 78c(f).

843 *See* 15 U.S.C. 78w(a)(2).

the benefits and costs to retail investors and broker-dealers, and also takes into account the broader implications of Regulation Best Interest for efficiency, competition, and capital formation.

Where possible, the Commission has sought to quantify the likely economic effects of Regulation Best Interest. The Commission is providing both a qualitative assessment and quantified estimates of the potential effects of Regulation Best Interest, where feasible. The Commission has incorporated data and other information provided by commenters to assist it in the analysis of the economic effects of Regulation Best Interest.[844] However, as explained below in more detail, because the Commission does not have, has not received, and, in certain cases, does not believe it can reasonably obtain data that may inform on certain economic effects, the Commission is unable to quantify certain economic effects. The Commission further notes that even in cases where it has some data or it has received some data regarding certain economic effects, the quantification of these effects is particularly challenging due to the number of assumptions that it would need to make to forecast how broker-dealers will respond to Regulation Best Interest, and how those responses will, in turn, affect the broader market for investment advice and the retail customers' participation in financial markets.

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[844] *See infra* Section III.A.3.

2. Broad Economic Considerations

Investors generally derive utility from consuming goods and services over their lifetime and from bequeathing wealth to others.[845] The amount of goods and services that an investor can consume or the amount of wealth the investor can bequeath is limited by the value of the resources available to the investor over his or her lifetime. These resources generally vary across market and economic conditions and over time. An investor generally seeks to allocate his or her resources across market and economic conditions and over time to achieve the highest expected utility possible over his or her lifetime. For example, an investor may decide to save, and therefore allocate, a proportion of his or her wages to maximize his or her expected utility from bequeathing wealth toward his or her children's future education.

Capital markets facilitate this allocation and reallocation of resources. An investor can allocate available resources across financial assets available to them in the capital markets, such that these resources become available to the investor at the times, and in the market and economic conditions, when he or she needs them. There may be many combinations of financial assets or investment strategies that achieve an investor's allocation goals, but each of these strategies may not necessarily provide the investor with the same benefits or cause the investor to bear the same costs. The expected benefit of allocating resources to an investment strategy depends on the expected utility to the investor from the expected payoff of the strategy and from

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845 *See, e.g.*, Irving Fisher, THE THEORY OF INTEREST, AS DETERMINED BY IMPATIENCE TO SPEND INCOME AND OPPORTUNITY TO INVEST IT (1930).

whether this strategy pays off in the market and economic conditions and at the times that the investor cares about. Importantly, the various costs of allocating resources to any strategy reduce the resources available for consumption and saving.

A rational investor seeks out investment strategies that are *efficient* in the sense that they provide the investor with the highest possible expected net benefit, in light of the investor's investment objective that maximizes expected utility.[846] From the discussion above, an efficient investment strategy may depend on the investor's utility from consumption, including: (1) his or her risk tolerance; (2) time available for the funds to be invested, and not consumed; (3) the resources that the investor has currently available (e.g., current wealth) or anticipates to become available at some point in the future (e.g., future income); and (4) the cost to the investor of implementing the strategy. An investor's efficient investment strategy may change over time because the investor's preferences, as well as market conditions and investment performance, may change over time.

In general, a typical investor may not have the knowledge or the time to identify efficient strategies on his or her own. In addition, investors may be limited in their access to information and their human computational capacity when evaluating choices.[847] As an alternative to

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846 *See, e.g.*, Andreu Mas-Colell, Michael D. Whinston, & Jerry R. Green, MICROECONOMIC THEORY (1995), specifically Chapter 10: Competitive Markets for a discussion of efficient allocations of resources.

847 *See, e.g.*, Herbert A. Simon, *A Behavioral Model of Rational Choice,* 69 Q. J. ECON. 99 (1955) for one of the first works on bounded rationality. *See also* Richard H. Thaler,

attempting to identify efficient strategies on his or her own, an investor may solicit advice from financial professionals.

While there are many types of financial professionals[848] that can provide advice related to a retail customer's finances, we focus here (and in Regulation Best Interest) on a type of professional that retail customers commonly access, namely broker-dealers and their associated persons.

A broker is any person engaged in the business of effecting transactions in securities for the account of others.[849] A dealer is any person engaged in the business of buying and selling securities for its own account, through a broker or otherwise.[850] Within the scope of these definitions, a "broker-dealer" (or, a firm that fits both definitions) may offer a wide variety of services to retail customers. These services include buying and selling securities for the retail customer as well as providing limited personalized investment advice in the form of

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Behavioral Economics: Past, Present, and Future, 106 AM. ECON. REV. 1577 (2016) for a discussion of the evolution of bounded rationality in economics.

848 The list of financial professionals that can provide advice related to a retail customer's finances includes broker-dealers and their associated persons, investment advisers, banks, and insurance agents.

849 *See* Section 3(a)(4)(A) of the Securities Exchange Act.

850 *See* Section 3(a)(5)(A) of the Securities Exchange Act.

recommendations of whether or not to engage in securities transactions or investment strategies involving securities.[851]

Federal securities laws and SRO rules govern broker-dealers' conduct of business. Among other things, they require that a broker-dealer or associated person "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is *suitable* for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's investment profile."[852] While a suitable recommendation must take into account the elements of a retail customer's investment profile that make securities transactions or an investment strategy efficient for that particular retail customer, this requirement for suitability may not lead to an efficient result for the retail customer.

The efficiency of a recommendation to a retail customer may depend on: (1) the menu of securities transactions and investment strategies the broker-dealer or its associated persons considers and makes available to the retail customer; (2) the return distribution and the costs of these securities transactions and strategies; (3) the associated person's understanding of these

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851 We focus our discussion on recommendations that are the focus of Regulation Best Interest but note that broker-dealers and their representatives provide a wide variety of "agency services" as described in footnote 1 of the Proposing Release. *See, e.g.*, 913 Study. *See also infra* Section III.B.1.a.

852 *See* FINRA Rule 2111 (Suitability); *see also infra* Section III.B.2.b.

investment options and the retail customer's objectives, such as the retail customer's risk tolerance and time preference; and (4) the retail customer's resource constraints.

A recommendation provided by an associated person of the broker-dealer may be influenced by the conflicts of interest that the associated person may have or the conflicts of interest that the broker-dealer may have at the time of the recommendation. These conflicts can arise as a result of how broker-dealers generate revenue from various securities or investment strategies that they make available to retail customers and how broker-dealers compensate their associated persons for providing recommendations to retail customers. In the United States, broker-dealers may earn transaction-based compensation that is commonly paid either directly by the retail customer (e.g., commissions and markups or markdowns) or indirectly through the investment sponsor (e.g., 12b-1 fees or revenue sharing). Broker-dealers may compensate their associated persons that provide recommendations to retail customers with a portion of the commissions and markups or markdowns these persons generate through their recommendations. Such financial incentives can vary depending on the investment product line, account type, or other factors (e.g., amount of customer assets brought into the broker-dealer or revenue generated from customer accounts).

A retail customer generally chooses to accept or reject a recommendation supplied by the associated person of the broker-dealer.[853] Some retail customers may base their decisions on an assessment of whether the recommendations they receive would result in securities transactions or investment strategies that are efficient for them. These customers' assessment may depend on factors such as their perception of the associated person's ability to properly understand and account for the customer's objectives, any information they have about the associated person's or firm's conflicts of interest with respect to that recommendation, and the extent to which these conflicts are expected to result in less than efficient recommendations for the retail customer. However, other retail customers may rely in full or in part on factors less directly related to the recommendation at hand. Instead, they might rely on factors such as their level of trust with the associated person or firm, and in certain circumstances might be inclined to simply accept all of the associated person's recommendations without evaluating for themselves whether the recommendations are efficient.[854]

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853 Note, however, that a retail customer may receive automated advice without involvement of an associated person of the broker-dealer. For example, a broker-dealer may generate recommendations through an asset allocation model. FINRA Regulatory Notice 12-25; *See also* FINRA Report on Digital Investment Advice (Mar. 2016).

854 *See, e.g.*, the discussion on investor trust in the markets for financial advice in Section III.B.4.a, *infra*. *See also* Gross Letter. *See also* Roman Inderst & Marco Ottaviani, *How (not) to pay for advice: A framework for consumer financial protection*, 105 J. FIN. ECON 393 (2012) for a discussion of the economic surplus extracted by broker-dealers that provide recommendations to retail customers, and how this surplus relates to the factors that determine a retail customer's decision to accept or reject a recommendation.

As noted above, broker-dealers or their associated persons may have conflicts of interest that could influence their recommendations to retail customers at the time when they are provided.

A retail customer's choice to accept a particular recommendation often directly affects the compensation that an associated person or broker-dealer itself receives. For example, an associated person may receive greater compensation from selling certain securities or strategies relative to other securities or strategies. Differences in compensation across the securities or strategies offered by a broker-dealer may add complexity to an associated person's incentives and may create conflict between the interests of the associated person, who desires to maximize his or her compensation, and the interests of the retail customer, who expects the recommended transaction to be efficient for him or her.

In general, this conflict of interest may result in a broker-dealer recommending securities or investment strategies that are less efficient for the retail customer. For instance, the recommended securities or strategies may be enhancing the associated person's compensation at the expense of the retail customer. Put another way, because of the financial incentives, broker-dealers and their associated persons may be motivated to recommend certain types or quantities of securities or strategies, and those recommendations may place the interests of the broker-dealer or its associated persons ahead of the interests of the retail customer, which may not result in the retail customer maximizing his or her expected net benefit. An inefficient recommendation may lead to various results for the retail customer, including inferior investment outcomes, such as risk-adjusted expected returns that are lower relative to other similar investments or investment strategies.

A retail customer may accept a recommendation that is less efficient if he or she is unable to assess correctly the efficiency of the recommendation..

The difference between the net benefit to the retail customer from accepting a less than efficient recommendation about a securities transaction or investment strategy, where the associated person or broker-dealer puts its interests ahead of the interests of the retail customer, and the net benefit the retail customer might expect from a similar securities transaction or investment strategy that is efficient for him or her, as defined above, is an *agency cost*.[855] As discussed in the Proposing Release and above, this agency cost arises because of the conflicts of interest of the broker-dealer and its associated persons, and the differences between the information sets available to the broker-dealer and the retail customer at the time of the recommendation.

In certain principal-agent relationships, the principal may be able to reduce the agency costs that he or she is facing in various ways, including by structuring the agent's compensation in a way that better aligns the interest of the agent with that of the principal.[856] A feature of the agency relationship between a retail customer (the principal) and a broker-dealer (the agent) that is common in many principal-agent relationships (including the investment adviser-client

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855 *See, e.g.,* Michael C. Jensen, and William. H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) for a more general discussion of agency costs.

856 *See, e.g.*, Stephen A. Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 AM. ECON. REV. (PAPERS & PROC.) 134 (1973).

relationship) is that the retail customer generally does not have full transparency about the agent's compensation for providing advice and the sources of the agent's compensation. Thus, the retail customer, through the decision to accept or reject a recommendation received, has generally limited understanding of and control over the compensation that the broker-dealer and its associated person obtains from providing the recommendation. These limitations restrict the retail customer's ability to reduce the agency costs that he or she is facing.

We also recognize that even if the retail customer were to have full transparency about the broker-dealer's and its associated person's compensation from providing advice, the retail customer's ability to reduce the agency costs may be constrained in other ways. For example, if the menu of securities from which the associated person of the broker-dealer offers recommendations is limited, the retail customer's and the associated person's ability to identify and select a more efficient investment may be constrained.

Different retail customers may face different agency costs depending on whether they base their decision to act on a recommendation on an assessment of the efficiency of the recommendation. Specifically, as noted above, a retail customer that evaluates and uses a recommendation received based on an assessment about the efficiency of that recommendation may be more successful in identifying and controlling, albeit in a limited fashion, the compensation that the broker-dealer and its associated person receive from the recommendation—such as by being more likely to reject a less than efficient recommendation—compared to a retail customer that makes this decision without forming an assessment of the efficiency of the recommendation. Thus, the agency costs may be higher for those retail customers that make their decision of whether to act on a recommendation received without an assessment of the efficiency of the recommendation.

While the discussion above focuses on the actions that the principal (i.e., the retail customer) can take to reduce the agency costs that he or she is facing, the agent can also take actions to reduce the agency costs to the principal. For example, in the agency paradigm, when the principal may forgo sharing a potentially large surplus with the agent because of the high agency costs, the agent may have an incentive to structure the terms of the relationship in a way that reduces the agency costs to the principal.[857] In the agency relationship between a retail customer and a broker-dealer, given the features of the compensation that the broker-dealer and its associated persons receive for providing recommendations (e.g., this compensation does not depend on the value of the assets in a principal's account), the broker-dealer and its associated persons may not have sufficient incentive to take actions voluntarily that would reduce agency costs to the retail customer, such as voluntarily increasing transparency with respect to compensation.[858]

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857 *See, e.g.*, Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986) for a discussion of the actions that agents can take to reduce the agency costs to the principal in the context of the relationship between an owner (the principal) and a manager (the agent) when the agent that has a valuable investment opportunity that can only be financed by the principal.

858 Limited transparency with respect to how broker-dealers and their associated persons are compensated from recommending a security and what constrains their menus of securities may make it difficult for retail customers to grasp the size of the agency costs that they are facing at the time when they receive the recommendation. As a result, this limited transparency may allow broker-dealers and their associated persons to extract informational rents (*i.e.*, in the context of a transaction, compensation in excess of what is competitively feasible that stems solely from the informational advantage of one party

Although the dynamics of the agency relationship between a retail customer and a broker-dealer may not cause the broker-dealer to take steps to increase transparency, competitive factors in the broker-dealer industry such as steps toward transparency taken by other broker-dealers may cause increased transparency in that relationship. Competitive dynamics are more effective in areas where comparisons can be more easily made. For example, in the market for mutual funds — particularly index funds —comparability and competition, among other factors, have driven down fees significantly.[859]

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over another) from the retail customers when providing recommendations. The adviser business model also has its own set of conflicted incentives to gather assets (based on AUM fees) or maximize the time that it takes to complete a job (if paid an hourly fee). Dual-registrants also have an incentive to recommend the type of account that is most profitable to the firm. *See* AFL-CIO April 2019 Letter. *See also* Morgan Lewis Letter (describing investment adviser compensation and conflicts disclosure in Form ADV); Bruce Ian Carlin & Gustavo Manso, *Obfuscation, Learning, and the Evolution of Investor Sophistication*, 24 REV. FIN. STUD. 754 (2011) for a discussion about the relationship between informational rents and the opacity of recommended investments (e.g., securities with complex payoff structures).

[859] Comparability among index funds that follow the same market index is facilitated in part by their passive style of investing. Actively managed funds that follow the same investment strategy can show different performance due to, among other things, the "skill" of the manager of outperforming the market (or any other benchmark). This skill is unobservable and generally hard to measure, which makes comparisons across actively managed funds difficult. In contrast, comparisons across index funds that follow the same market index and that have passive investment styles are based more on observable variables, such as fees, rather than unobservable variables, such as managerial skill. In this context, disclosure that is more salient with respect to these observable variables may facilitate comparisons across index funds.

While we do not have evidence to establish the degree to which broker-dealers can extract large informational rents from retail customers under the current legal and regulatory regime that governs the broker-dealers' standard of conduct, the existing agency costs of the relationship between the retail customer and the broker-dealer would likely be larger, absent the current legal and regulatory regime.[860] In general, standards and regulation are effective means of reducing agency costs when principals (e.g., retail customers) and agents (e.g., broker-dealers) cannot reduce the agency costs on their own by negotiating to address the market frictions in their relationship through mechanisms available to them, such as bilateral contracting[861] or "side payments."[862]

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860 *See, e.g.*, Matthew L. Kozora, *Security Recommendations and the Liabilities of Broker-Dealers* (U.S. Sec. & Exch. Comm'n, Working Paper, May 1, 2016)*, available at* https://www.sec.gov/files/Kozora_BD-Liability_05-2016.pdf, which provides evidence from investor awards in FINRA arbitrations that the author interprets as indicative of informational rents being nonzero. *See also* our more comprehensive discussion in Section III.B.3.c, *infra*, about potential investor harm associated with investment advice, including from potential informational rents.

861 *See* Proposing Release at 21643.

862 Another way principals and agents negotiate around market frictions is through "side payments." In a transaction between two parties, a side payment is a monetary exchange from one party to another that is not part of the transaction. This mechanism is discussed in the literature on bilateral externalities, which focuses on how the actions of one party can affect the well-being of the other party. This mechanism also applies to the relationship between a broker-dealer and a retail customer because the action taken by a broker-dealer, namely providing a recommendation, may affect the well-being of the retail customer receiving that recommendation. In the literature on bilateral externalities, if the party taking these externality actions is unconstrained, the allocation of resources across the two parties may be inefficient. However, in certain circumstances, the parties

Regulation Best Interest enhances the current standard of conduct for broker-dealers and codifies it in an Exchange Act rule. Regulation Best Interest is designed to: (1) enhance the current standard of conduct applicable to broker-dealers and associated persons when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities; (2) reduce conflicts of interest that currently exist between retail customers and broker-dealers and their associated persons; and (3) reduce information asymmetries that currently limit the ability of retail customers to evaluate the efficiency of recommendations they receive from broker-dealers and their associated persons. In each of these three ways, Regulation Best Interest is designed to reduce the agency costs in the relationship between broker-dealers and their retail customers, including in situations where the existing legal and regulatory regime that governs broker-dealers' standard of conduct has had limited effectiveness.

3. Comments on Market Failure of the Principal-Agent Relationship and Quantification; Comments that the Broker-Dealer, Commission-Based Model Should Be Severely Restricted or Eliminated

The economic analysis in the Proposing Release characterized the relationship between a retail customer and a broker-dealer as one between a principal (the retail customer) and an agent (the broker-dealer).[863] The analysis noted that the potential conflict between interests and the

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can avoid this inefficient outcome through side payments that neutralize the effect of the externality on the allocations. *See, e.g.*, Mas-Colell et al. (1995), *supra* footnote 846, specifically Part 3: Market Equilibrium and Market Failure for a discussion of bilateral externalities.

863 *See* Proposing Release at 21629-21631.

differences between the information sets available to the agent and the principal may result in agency costs. It further noted that the inability of the broker-dealers and retail customers to overcome the market frictions underlying these agency costs may result in inefficient allocations of resources. An inability of the principal and the agent to efficiently negotiate around the frictions that produce agency costs and take actions that would increase the efficiency of their allocations is what economists refer to as a "market failure" of the principal-agent relationship,[864] generally, and of the agency relationship between the retail customer and the broker-dealer, specifically.[865]

The analysis in the Proposing Release recognized that while the Commission cannot provide a quantified estimate of the magnitude of this agency cost, the existence of these costs and their persistence justifies regulatory intervention.[866]

A number of commenters questioned this approach. Certain of these commenters stated that the Commission needs to more fully identify the market failure that needs to be addressed, and certain commenters stated that the Commission did not provide a quantitative assessment of

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[864] *See, e.g.*, Mas-Colell et al. (1995), *supra* footnote 846.

[865] In general, because frictions such as asymmetric information are ever present, all markets and agency relationships have some degree of market failure.

[866] *See* Proposing Release at 21631.

the severity of the market failure that would prompt the need for regulatory intervention.[867] We address these concerns below.

With respect to the issue of appropriately identifying the market failure, one commenter questioned whether the relationship between the retail customer and the broker-dealer is a principal-agent relationship.[868] This commenter stated that in many instances, a broker-dealer's

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[867] *See, e.g.*, CFA August 2018 Letter at 105, noting that "[c]orrectly diagnosing the problem requires identifying and analyzing the market failure that has occurred in investment advice securities markets, as well as assessing the significance of that problem"; *See also, e.g.*, Letter from Charles Cox, Former SEC Chief Economist, et al. (Feb. 6, 2019) ("Former SEC Senior Economists Letter") at 2, noting that "the Commission confronts important questions about advisers balancing their own compensation against the effect of that compensation on the customer's expected returns. We wonder if the extreme asymmetry of information and financial sophistication between advisers and many of their clients constitutes a market failure that the April proposals are intended to ameliorate." In addition, the Former SEC Senior Economists Letter raised three main concerns with the economic analysis in the Proposing Release: 1) the discussion of the potential problems in the customer-adviser relationship was incomplete and identified other features of the market for ongoing retail investment advice that might be problematic; 2) there was inadequate discussion and analysis of the existing economic literature on financial advice; and 3) there were questions of whether the disclosure requirements in the Proposing Release would provide meaningful information for customers. The economic analysis addresses these concerns. For instance, with respect to 1), Section III.A.2 provides a more in depth discussion of the potential problems that may arise when a broker-dealer provides recommendations to a retail customer. With respect to 2), Section III.B.3 engages more fully with the economic literature on financial advice. Finally, with respect to 3), Sections III.B.4, III.C.2, and III.C.4 provide discussions on the effectiveness of the disclosure requirements of Regulation Best Interest.

[868] *See* CFA August 2018 Letter at 107, noting that "[t]he Commission's economic analysis gets off to a faulty start by mischaracterizing, or at least over-simplifying, the broker-customer 'advice' relationship, as a principal-agent relationship. While there are certainly instances where a broker and its customer can exhibit features of a bona fide principal-agent relationship—for example when executing a customer's order—it's not clear that,

provision of recommendations to a retail customer resembles an arm's length transaction (e.g., purchasing a car) that benefits the more informed broker-dealer at the expense of the less informed retail customer. This commenter disagreed with the Commission's broader view that the market failure stems from the agency costs of the relationship between a broker-dealer and a retail customer,[869] and instead stated that the market failure is due to conflicts of interest caused by the way broker-dealers and their associated persons are generally compensated for providing recommendations to retail customers.[870] Similarly, another commenter stated that the Commission failed to discuss how the current compensation practices associated with providing recommendations to retail customers creates incentives for the broker-dealer and its associated persons to favor one securities transaction or investment strategy over another when making recommendations to retail customers.[871] This commenter further questioned whether the

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in the context of receiving investment recommendations, those same characteristics are present. Certainly, the brokerage industry expressly refutes this characterization, having argued successfully in the Fifth Circuit that brokers engage in nothing more than an arm's length commercial sales transaction, no different from a car dealer soliciting interest in inventory."

869 *See* CFA August 2018 Letter at 108, noting that "[t]ypically, principal-agent relationships don't involve third party payments to the agent, which can adversely affect the level of loyalty the agent provides to the principal."

870 *See* CFA August 2018 Letter at 107, noting that the Commission "fails to acknowledge that conflicts of interest are a real problem that result in real harm to investors […]" and "[…] the Release fails to make clear whether the Commission is truly seeking to address the underlying problem of conflicts' harmful impact on investors."

871 *See* Former SEC Senior Economists Letter at 3, noting that "[n]owhere does the EA emphasize that an adviser's compensation provides numerous opportunities for her to

information asymmetry and the discrepancy in the level of financial sophistication between broker-dealers and their retail customers constitute a market failure.[872] One commenter noted that the poor performance of actively managed funds that are being recommended by broker-dealers to small retail customers reflects a principal-agent problem that causes an "enormous" wealth transfer from retail customers to the financial industry, including broker-dealers.[873] This commenter stated that this problem arises because of the broker-dealer's commission-based compensation for providing recommendations and because of the information asymmetries between the broker-dealer and the retail customer at the time of the recommendation.[874] This

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favor one investment over another on the basis of the compensation it pays to her or to her firm."

872 *See* Former SEC Senior Economists Letter at 2. *See also supra* footnote 867 that describes in more detail the concerns raised by this commenter.

873 *See* Letter from Monique Morrissey, Economist and Heidi Shierholz, Senior Economist and Director of Policy, EPI (Aug. 7, 2018) ("EPI Letter") at 6, noting that "[i]n an equilibrium with knowledgeable investors, we would expect returns from active and passive strategies to be equal. The fact that actively-managed funds marketed to small investors tend to perform poorly reflects a market distortion—naiveté—or a 'principal-agent problem' in economics parlance, which results in enormous transfers from investors to the financial industry."

874 *See* EPI Letter at 2, noting that "[c]onflicts of interest between buyers and sellers are commonplace. Many salesmen, including brokers and car dealers, are paid on commission. However, it has long been recognized that markets for professional advice are different from markets for automobiles because information asymmetries are inherent in these transactions."

commenter also stated that recommendations subject to conflicts of interest may have no value for retail customers.[875]

As an initial matter, in response to comments regarding the need to discuss fully the existing market failure, it is important to recognize that the Commission has been studying and carefully considering the issues related to the broker-dealer-client relationship and the related standard of conduct for broker-dealers for many years, which led to the development of the Proposing Release and the economic analysis therein.[876] In light of the comments on the Proposing Release, the extensive outreach by the Commission and staff, as well as investor testing, the Commission has more specifically and fully described the relationship between the broker-dealer and the client, the related market failure, and the resulting potential economic effects of Regulation Best Interest in addressing the market failure.[877]

The Commission continues to believe that agency costs are at the root of existing allocative inefficiencies in the market for broker-dealer advice. Moreover, this economic analysis recognizes that a proper understanding of the economic fundamentals of an investor's

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875 *See* EPI Letter at 8, noting that "the SEC never considers that 'advice' offered may not just be of lower quality than expected, but worse than no advice at all" and that "much of the 'advice' provided by broker-dealers not only lacks value, but is actually harmful, steering savers to higher-cost products and costly services that will reduce their future standard of living compared to how they would fare in the absence of this 'advice.' This may be true whether or not, in the absence of conflicted 'advice,' investors would have availed themselves of more paid or free advice from more impartial sources."

876 *See* Proposing Release at 21579-21583.

877 *See supra* Section III.A.2.

decision to allocate resources across market and economic conditions and over time is central to identifying the frictions that cause inefficiencies in the agency relationship between a broker-dealer and a retail customer.

In response to the commenter that stated that in a principal-agent relationship agents do not receive compensation from third parties (e.g., investment sponsors), the Commission notes that the compensation that the investment sponsor provides to the agent is ultimately funded by the principal (i.e., the retail customer).[878] In addition, in response to the commenter's concern that a broker-dealer's provision of recommendations to retail customers resembles an arm's length transaction that is "no different from a car dealer soliciting interest in inventory,"[879] the Commission notes that under the current regulatory regime broker-dealers and their associated persons are subject to a suitability standard of conduct that has been interpreted to "be consistent with [the] customer's best interests."[880] In contrast, in an arm's length transaction, the parties involved are generally not subject to a standard of conduct that would constrain the more informed party from acting solely in its own interest.[881] Finally, in response to the commenter's

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878 *See supra* footnote 869.

879 *See supra* footnote 868.

880 *See infra* footnote 979 and accompanying text.

881 However, in certain markets, there may be market mechanisms in place that would prevent the more informed party to a transaction from acting solely in its own interest.

concern with respect to the identification of the market failure,[882] the Commission notes that while conflicts of interest arise in many types of transactions, in certain instances the parties involved can negotiate an arrangement between themselves that would reduce the effect of conflicts of interest on the allocation of resources across the parties and improve the efficiency of this allocation. The Commission further notes that agency costs may deter the parties from engaging in privately negotiated arrangements that would improve the efficiency of the allocation of resources between the parties. From this perspective, the Commission believes that it is the agency costs rather than the conflicts of interest themselves that should be viewed as the source of the market failure.

In response to the commenter that noted that the Commission did not discuss how the compensation received by the broker-dealer and its associated persons creates incentives to favor one security or investment strategy over another when making recommendations to retail customers,[883] the Commission has incorporated into this economic analysis a detailed discussion of the incentives created by the current compensation practices associated with providing recommendations to retail customers.[884] In addition, in response to the commenter's concerns about whether the information asymmetry and the discrepancy in the level of financial sophistication between retail customers and a broker-dealer and its associated persons are the

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882 *See supra* footnote 870.

883 *See supra* footnote 871.

884 *See infra* Section III.C.4.

source of market failure, the Commission notes that this economic analysis establishes a more clear link between bounded rationality, including access to information and financial literacy of retail customers, and agency costs, and reflects our conclusion that the agency costs are at the root of the market failure.

The Commission further notes that the so-called "informational rent" that a broker-dealer may be incentivized to extract from a retail customer to take advantage of the information asymmetry or the discrepancy in the level of financial sophistication is one component of the agency costs associated with the relationship between a retail customer and a broker-dealer. In addition, the Commission notes that the evidence on the size of the agency costs associated with such informational rents is limited.[885] This evidence is not generally supportive of a commenter's assessment that the wealth transfer from retail customers to broker-dealers is "enormous."[886] The Commission agrees with this commenter, who stated that the way broker-dealers are compensated for providing recommendations and the information asymmetry between retail customers and broker-dealers are important determinants of the agency costs. However, based on the evidence discussed below, the Commission disagrees with this

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[885] *See supra* Section III.A.2 and *infra* Section III.B.3.

[886] *See supra* footnote 873.

commenter's assessment that the advice provided by the associated persons of the broker-dealer has no value.[887]

With respect to the issue of measuring the severity of the market failure, some commenters stated that the Commission failed to take into account existing academic literature that provides evidence of investor harm caused by accepting advice from the associated persons of the broker-dealer. A subset of these commenters believed that the evidence provided in some of these academic studies is compelling and that the Commission should use it to quantify the severity of the market failure.[888] One commenter also urged the Commission to supplement the academic evidence on investor harm with evidence from data available to the Commission from regulatory oversight.[889]

In response to these comments, the Commission maintains that the existence of misconduct that commenters requested the Commission to document does not render the approach taken in Regulation Best Interest irrational, inappropriate, or unreasonable, nor does it suggest that an alternative approach would be more effective in fulfilling the Commission's mission. The Commission is aware and understands the concerns raised by the commenters with

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887 *See infra* Section III.B.3.b.

888 *See, e.g.*, CFA August 2018 Letter; EPI Letter; AARP August 2018 Letter; Better Markets August 2018 Letter; Former SEC Senior Economists Letter.

889 *See* CFA August 2018 Letter at 112. This commenter suggested that we present additional information about the existence and frequency of the potential harm to investors "that results from conflicted brokerage 'advice'," which may collectively be seen as misconduct by financial professionals.

regards to the evidence on investor harm and the extent to which such evidence can inform on our understanding of the severity of the market failure in the market for broker-dealer advice. As discussed in the Proposing Release and reiterated in this economic analysis, the Commission believes that retail investors can be harmed when they accept recommendations from a broker-dealer that places the financial or other interest of the broker-dealer or its associated persons ahead of the interests of the retail customers. In addition, this economic analysis engages more fully with the economic literature on financial advice and considers these studies in analyzing the costs and benefits associated with Regulation Best Interest.[890]

B. Economic Baseline

This section discusses, as it relates to this rulemaking, the current state of the broker-dealer and investment adviser markets; the current regulatory environment and market practices surrounding the provision of recommendations by broker-dealers; evidence on the potential value and harm of investment advice; and how issues related to trust, financial literacy, and disclosure effectiveness affect conflicts between investors and financial professionals. The economic baseline has been revised and expanded relative to the Proposing Release to address comments, discussed more fully below.

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[890] *See infra* Section III.B.3.c.

1. Providers of Financial Services[891]

a. Broker-Dealers

Regulation Best Interest will affect the market for broker-dealer services, including firms that are dually registered as broker-dealers and investment advisers[892] and broker-dealers affiliated with an investment adviser.[893] The market for broker-dealer services encompasses a

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891 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 bank holding companies, and insurance companies, which also provide financial advice services to retail customers; however, because of unavailability of data, the Commission is unable to estimate the number of some of those other entities that are likely to provide financial advice to retail customers as well as their size and the scope of services they provide. A number of broker-dealers (*see infra* footnote 899) have non-securities businesses, such as insurance or tax services. As of December 2018, there were approximately 17,300 state-registered investment advisers. The Department of Labor in its Regulatory Impact Analysis identifies approximately 398 life insurance companies that could provide advice to retirement investors. *See infra* footnote 1002.

892 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 dually registered firms offer advisory accounts to retail investors but offer only brokerage services, such as underwriting services, to institutional clients. For purposes of the discussion of the baseline in this economic analysis, a dually registered firm is any firm that is dually registered with the Commission as an investment adviser and a broker-dealer.

893 Some broker-dealers may be affiliated with investment advisers and not dually registered. From Question 10 on Form BD, 2,098 (55.7%) broker-dealers report that, directly or indirectly, they control, are controlled by, or are under common control with an entity that is engaged in the securities or investment advisory business. Comparatively, 2,421 (18.2%) SEC-registered investment advisers report an affiliate that is a broker-dealer in Section 7A of Schedule D of Form ADV, including 1,878 SEC-registered investment

small set of large and medium sized broker-dealers and thousands of smaller broker-dealers competing for niche or regional segments of the market.[894] The market for broker-dealer services includes many different markets for a variety of services, including (1) managing orders for customers and routing them to various trading venues; (2) providing advice to customers that is in connection with and reasonably related to their primary business of effecting securities transactions;[895] (3) holding retail customers' funds and securities; (4) handling clearance and settlement of trades; (5) intermediating between retail customers and carrying/clearing brokers; (6) dealing in corporate debt and equities, government bonds, and municipal bonds, among other securities; (7) privately placing securities; and (8) 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 2018, there were approximately 3,764 registered broker-dealers with over 140 million customer accounts. In total, these broker-dealers have over $4.3 trillion in total

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advisers that report an affiliate that is a registered broker-dealer. Approximately 77% of total regulatory AUM are managed by the 2,421 SEC-registered investment advisers.

894 *See* Risk Management Controls for Brokers or Dealers with Market Access, Securities Exchange Act Release No. 63241 (Nov. 3, 2010) [75 FR 69791, 69822 (Nov. 15, 2010)]. For simplification, we present our analysis as if the market for broker-dealer services encompasses one broad market with multiple segments, even though, in terms of competition, it could also be discussed in terms of numerous interrelated markets.

895 *See* Solely Incidental Interpretation.

assets, which are total broker-dealer assets as reported on Form X-17a-5.[896] More than two-thirds of all brokerage assets and close to one-third of all customer accounts are held by the 17 largest broker-dealers, as shown in Table 1, Panel A.[897] Of the broker-dealers registered with the Commission as of December 2018, 563 broker-dealers were dually registered as investment advisers.[898] These firms hold over 90 million (63%) customer accounts. Approximately 539 broker-dealers (14%) report at least one type of non-securities business, including insurance, retirement planning, mergers and acquisitions, and real estate, among others.[899] Approximately 73.5% of registered broker-dealers report retail customer activity.[900]

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896 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) 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.

897 Approximately $4.24 trillion of total assets of broker-dealers (98%) are at broker-dealers with total assets in excess of $1 billion. Of the 33 dual-registrants in the group of broker-dealers with total assets in excess of $1 billion, total assets for these dual-registrants are $2.32 trillion (54%) of aggregate broker-dealer assets. Of the remaining 99 broker-dealers with total assets in excess of $1 billion that are not dual-registrants, 91 have affiliated investment advisers.

898 This number includes the number of broker-dealers who are also registered as state investment advisers. For purposes of the discussion of the baseline in this economic analysis, a dual-registrant is any firm that is dually registered with either the Commission or a state as an investment adviser and a broker-dealer. Excluding state registered advisers, there are 359 entities that are dually registered with the Commission as an investment adviser and a broker-dealer.

899 We examined Form BD filings to identify broker-dealers reporting non-securities business. For the 393 broker-dealers reporting such business, staff analyzed the narrative

Panel B of Table 1 is limited to the broker-dealers that report some retail investor activity. As of December 2018, there were approximately 2,766 broker-dealers that served retail investors, with over $3.8 trillion in total assets (89% of total broker-dealer assets) and almost 139 million (97%) customer accounts.[901] Of those broker-dealers serving retail investors, 452 were dually registered as investment advisers.[902] The number of broker-dealers that serve retail customers

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descriptions of these businesses on Form BD, and identified the most common types of businesses: insurance (202), management/financial/other consulting (99), advisory/retirement planning (71), mergers and acquisitions (70), foreign exchange/swaps/other derivatives (28), real estate/property management (30), tax services (15), and other (146). Note that a broker-dealer may have more than one line of non-securities business.

900 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.

901 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.

902 Excluding state registered advisers, there are 359 entities that are dually registered with the Commission as an investment adviser and a broker-dealer. Of the 31 dual-registrants in the group of retail broker-dealers with total assets in excess of $500 million, total assets for these dual-registrants are nearly $2.01 trillion (53%) of aggregate retail broker-dealer assets (Table 1, Panel B). Of the remaining 81 retail broker-dealers with total assets in excess of $500 million that are not dual-registrants, 76 have affiliated investment advisers.

(i.e., 2,766) likely overstates the number of broker-dealers that will be subject to Regulation Best Interest, because not all broker-dealers that serve retail investors provide recommendations to retail investors. We do not have reliable data to determine the precise number of broker-dealers that provide recommendations (and the extent to which broker-dealers that provide recommendations do so, as opposed to executing unsolicited trades), and as a result, we have assumed, for purposes of this Section III and Sections IV (Paperwork Reduction Act Analysis) and V (Final Regulatory Flexibility Act Analysis) that 2,766 broker-dealers will be subject to Regulation Best Interest.

Table 1, Panel A: Registered Broker-Dealers as of December 2018[903]

Cumulative Broker-Dealer Total Assets and Customer Accounts[904]

Size of Broker-Dealer (Total Assets)	Total Num. of BDs	Num. of Dually Registered BDs	Cumulative Total Assets	Cumulative Number of Customer Accounts[905]
> $50 billion	17	10	$2,879 bil.	40,550,200
$1 billion to $50 billion	114	23	$1,363 bil.	96,037,591
$500 million to $1 billion	35	7	$23 bil.	397,814
$100 million to $500 million	105	20	$23 bil.	1,603,818
$10 million to $100 million	490	115	$17 bil.	4,277,432
$1 million to $10 million	1,021	182	$3.6 bil.	460,748
< $1 million	1,982	206	$0.5 bil.	5,675
Total	3,764	563	$4,309 bil.	143,333,278

903 The data is obtained from FOCUS filings as of December 2018. 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.

904 In addition to the approximately 143 million individual accounts at broker-dealers, there are approximately 302,000 omnibus accounts (0.2% of total accounts at broker-dealers), with total assets of $32.1 billion, across all 3,764 broker-dealers, of which approximately 99% are held at broker-dealers with greater than $1 billion in total assets. *See also supra* footnote 897. 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 under inclusive of all customer accounts held at broker-dealers.

905 Customer Accounts includes both broker-dealer and investment adviser accounts for dual-registrants.

Table 1, Panel B: Registered Retail Broker-Dealers as of December 2018

Cumulative Broker-Dealer Total Assets and Customer Accounts

Size of Broker-Dealer (Total Assets)	Total Num. of BDs	Num. of Dually Registered BDs	Cumulative Total Assets	Cumulative Number of Customer Accounts
> $50 billion	16	8	$2,806 bil.	40,545,792
$1 billion to $50 billion	75	18	$990 bil.	91,991,118
$500 million to $1 billion	21	5	$13 bil.	365,632
$100 million to $500 million	84	17	$18 bil.	1,603,818
$10 million to $100 million	378	96	$14 bil.	3,762,620
$1 million to $10 million	783	153	$2.8 bil.	450,132
< $1 million	1,409	155	$0.4 bil.	5,672
Total BDs[906]	2,766	452	$3,844 bil.	138,724,784

Table 2 reports information on brokerage commissions,[907] fees, and selling concessions from the fourth quarter of 2018 for all broker-dealers, including dual-registrants.[908] We observe significant variation in the sources of revenues for broker-dealers, with large broker-dealers, on average, generating substantially higher levels of aggregate commission and fee revenues (on a nominal basis) than smaller broker-dealers. On average, broker-dealers, including those that are

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906 Total BDs includes all retail-facing broker-dealers, including those dual-registrants that have retail-facing broker-dealers.

907 Mark-ups or mark-downs are not included as part of the brokerage commission revenue in FOCUS data; instead, they are included in Net Gains or Losses on Principal Trades, but are not uniquely identified as a separate revenue category.

908 Source: FOCUS data.

dually registered as investment advisers, earn about $5.1 million per quarter in revenue from commissions and nearly four times that amount in fees,[909] although the Commission notes that fees encompass various types of fees, not just fees for advisory services.[910] The level of revenues earned by broker-dealers (including dually registered firms) for commissions and fees increases with broker-dealer size, but also tends to be more heavily weighted toward commissions for broker-dealers with less than $10 million in assets and is weighted more heavily toward fees for broker-dealers with assets in excess of $10 million. For example, for the 114 broker-dealers with

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[909] Fees, as detailed in the FOCUS data, include fees for account supervision, investment advisory services, and administrative services. Beyond the broad classifications of fee types included in fee revenue, we are unable to determine whether fees such as Rule 12b-1 fees, sub-accounting, or other such service fees (e.g., payments by an investment company for personal service and/or maintenance of shareholder accounts) are included. The data covers both broker-dealers and dually registered firms. FINRA's Supplemental Statement of Income, Line 13975 (Account Supervision and Investment Advisory Services) denotes that fees earned for account supervision are those fees charged by the firm for providing investment advisory services where there is no fee charged for trade execution. Investment Advisory Services generally encompass investment advisory work and execution of client transactions, such as wrap arrangements. These fees also include fees charged by broker-dealers that are also registered with the Commodity Futures Trading Commission ("CFTC"), but do not include fees earned from affiliated entities (Item A of question 9 under Revenue in the Supplemental Statement of Income).

[910] With respect to the FOCUS data, additional granularity of what services comprise "advisory services" is not available. *See also* Solely Incidental Interpretation.

assets between $1 billion and $50 billion, average revenues from commissions are approximately $45 million, while average revenues from fees are approximately $225 million.[911]

In addition to revenue generated from commissions and fees, broker-dealers may also receive revenues from other sources, including margin interest, underwriting, research services, and third-party selling concessions, such as from sales of investment company ("IC") shares. As shown in Table 2, Panel A, these selling concessions are generally a smaller fraction of broker-dealer revenues than either commissions or fees, except for broker-dealers with total assets between $10 million and $100 million. For these broker-dealers, revenue from third-party selling concessions is the largest category of revenues and constitutes approximately 42% of total revenues earned by these firms.

Table 2, Panel B below provides aggregate revenues by revenue type (commissions, fees, or selling concessions from sales of IC shares) for broker-dealers delineated by whether the broker-dealer is also a dual-registrant. Broker-dealers dually registered as investment advisers have a significantly larger fraction of their revenues from fees compared to commissions or selling concessions, whereas broker-dealers that are not dually registered generate approximately 42% of their advice-related revenues as commissions and only 33% of their advice-related revenues from fees, although we lack granularity to determine whether advisory services, in

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911 An estimate of total fees in this size category would be 114 broker-dealers with assets between $1 billion and $50 billion multiplied by the average fee revenue of $225 million, or $25.65 billion in total fees.

addition to supervision and administrative services, contribute to fees at standalone broker-dealers.

Table 2, Panel A: Average Broker-Dealer Revenues from Revenue Generating Activities[912]

Size of Broker-Dealer in Total Assets	N	Commissions	Fees[913]	Sales of IC Shares
> $50 billion	17	$170,336,258	$414,300,268	$23,386,192
$1 billion - $50 billion	114	$45,203,225	$225,063,257	$53,671,602
$500 million - $1 billion	35	$8,768,547	$30,141,270	$5,481,248
$100 million - $500 million	105	$12,801,889	$33,726,336	$16,610,013
$10 million - $100 million	490	$3,428,843	$8,950,892	$9,092,971
$1 million - $10 million	1,021	$996,130	$1,037,825	$652,905
< $1 million	1,982	$197,907	$269,459	$85,219
Average of All Broker-Dealers	3,764	$5,092,808	$21,948,551	$4,368,823

912 The data is obtained from December 2018 FOCUS reports and averaged across size groups.

913 Fees, as detailed in the FOCUS data, include fees for account supervision, investment advisory services, and administrative services. The data covers both broker-dealers and dually registered firms.

Table 2, Panel B: Aggregate Total Revenues from Revenue Generating Activities for Broker-Dealers based on Dual-Registrant Status

Broker-Dealer Type	N	Commissions	Fees[914]	Sales of IC Shares
Dually Registered as IAs	563	$4.62 bil.	$17.56 bil.	$2.65 bil.
Standalone Registered BDs	3,201	$4.07 bil.	$3.22 bil.	$2.55 bil.
All	3,764	$8.69 bil.	$20.78 bil.	$5.20 bil.

As shown in Table 3, based on responses to Form BD, broker-dealers' most commonly provided business lines include private placements of securities (62.7% of broker-dealers); retail sales of mutual funds (55.4%); acting as a broker or dealer retailing corporate equity securities over the counter (52.0%); acting as a broker or dealer retailing corporate debt securities (47.2%); acting as a broker or dealer selling variable contracts, such as life insurance or annuities (41.0%); acting as a broker of municipal debt/bonds or U.S. government securities (39.8% and 37.4%, respectively); acting as an underwriter or selling group participant of corporate securities (31.2%); and investment advisory services (26.4%), among others.[915]

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914 *See id.*

915 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 3 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 2018.

Table 3: Lines of Business at Retail Broker-Dealers as of December 2018

	Total	
Line of Business	**Number of Broker-Dealers**	**Percent of Broker-Dealers**
Private Placements of Securities	1,735	62.70%
Mutual Fund Retailer	1,533	55.40%
Broker or Dealer Retailing:		
Corporate Equity Securities OTC	1,438	51.97%
Corporate Debt Securities	1,306	47.20%
Variable Contracts	1,132	40.91%
Municipal Debt/Bonds Broker	1,101	39.79%
U.S. Government Securities Broker	1,035	37.41%
Put and Call Broker or Dealer or Options Writer	993	35.89%
Underwriter or Selling Group Participant - Corporate Securities	862	31.15%
Non-Exchange Member Arranging For Transactions in Listed Securities by Exchange Member	785	28.37%
Investment Advisory Services	730	26.38%
Broker or Dealer Selling Tax Shelters or Limited Partnerships – Primary Market	619	22.37%
Trading Securities for Own Account	614	22.19%
Municipal Debt/Bonds Dealer	475	17.17%
U.S. Government Securities Dealer	339	12.25%
Solicitor of Time Deposits in a Financial Institution	308	11.13%
Underwriter - Mutual Funds	237	8.57%
Broker or Dealer Selling Interests in Mortgages or Other Receivables	216	7.81%
Broker or Dealer Selling Oil and Gas Interests	207	7.48%
Broker or Dealer Making Inter-Dealer Markets in Corporate Securities OTC	207	7.48%
Broker or Dealer Involved in Networking, Kiosk, or Similar Arrangements (Banks, Savings Banks, Credit Unions)	197	7.12%
Internet and Online Trading Accounts	192	6.94%
Exchange Member Engaged in Exchange Commission Business Other than Floor Activities	171	6.18%
Broker or Dealer Selling Tax Shelters or Limited Partnerships – Secondary Market	164	5.93%
Commodities	162	5.85%
Executing Broker	107	3.87%

Day Trading Accounts	89	3.22%
Broker or Dealer Involved in Networking, Kiosk, or Similar Arrangements (Insurance Company or Agency)	88	3.18%
Real Estate Syndicator	94	3.40%
Broker or Dealer Selling Securities of Non-Profit Organizations	71	2.57%
Exchange Member Engaged in Floor Activities	61	2.20%
Broker or Dealer Selling Securities of Only One Issuer or Associate Issuers	43	1.55%
Prime Broker	21	0.76%
Crowdfunding FINRA Rule 4518(a)	21	0.76%
Clearing Broker in a Prime Broker	14	0.51%
Funding Portal	8	0.29%
Crowdfunding FINRA Rule 4518(b)	5	0.18%
Number of Retail-Facing Broker-Dealers	2,766	

b. Investment Advisers

Other parties that could be affected by Regulation Best Interest are SEC- or state-registered investment advisers, because Regulation Best Interest could affect the competitive landscape in the market for the provision of financial advice.[916] This section first discusses SEC-registered investment advisers, followed by a discussion of state-registered investment advisers.

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916 In addition to SEC-registered investment advisers, which are the focus of this section, Regulation Best Interest could also affect banks, trust companies, insurance companies, and other providers of financial advice.

As of December 2018, there were approximately 13,300 investment advisers registered with the Commission. The majority of SEC-registered investment advisers report that they provide portfolio management services for individuals and small businesses.[917]

Of all SEC-registered investment advisers, 359 identify themselves as dually registered broker-dealers.[918] Further, 2,421 investment advisers (18%) report an affiliate that is a broker-dealer, including 1,878 investment advisers (14%) that report an SEC-registered broker-dealer affiliate.[919] As shown in Panel A of Table 4 below, in aggregate, investment advisers have over $84 trillion in AUM. A 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, the total number of accounts for investment advisers is only 29% of the number of customer accounts for broker-dealers.

Based on staff analysis of Form ADV data, approximately 62% of registered investment advisers (8,235) have some portion of their business dedicated to retail investors, including both

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917 Of the approximately 13,300 SEC-registered investment advisers, 8,410 (63.24%) 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 17,300 state-registered investment advisers, of which 125 are also registered with the Commission. Approximately 13,900 state-registered investment advisers are retail facing (*see* Item 5.D of Form ADV).

918 *See supra* footnote 892.

919 Item 7.A.1 of Form ADV.

high net worth and non-high net worth individual clients,[920] as shown in Panel B of Table 4.[921] In total, these firms have approximately $41.4 trillion of AUM.[922] Approximately 8,200 registered investment advisers (61%) serve almost 32 million non-high net worth individual clients and have approximately $4.8 trillion in AUM, while approximately 8,000 registered investment advisers (60%) serve approximately 4.8 million high net worth individual clients with $6.15 trillion in AUM.[923]

Table 4, Panel A: Registered Investment Advisers (RIAs) as of December 2018

Cumulative RIA AUM and Accounts

Size of Investment Adviser (AUM)	Number of RIAs	Number of Dually Registered RIAs	Cumulative AUM	Cumulative Number of Accounts
> $50 billion	270	15	$59,264 bil.	20,655,756
$1 billion to $50 billion	3,453	121	$22,749 bil.	13,304,154
$500 million to $1 billion	1,635	47	$1,151 bil.	1,413,099

920 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 Regulation Best Interest because the data obtained from Form ADV regarding clients who are individuals does not involve any test of use for personal, family, or household purposes.

921 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. Part 1A of Form ADV.

922 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.

923 Estimates are based on IARD system data as of December 31, 2018. The AUM reported here is specifically that of those non-high net worth clients. Of the 8,235 investment advisers serving retail investors, 318 are also dually registered as broker-dealers.

$100 million to $500 million	5,927	119	$1,397 bil.	5,135,070
$10 million to $100 million	1,070	24	$59 bil.	310,031
$1 million to $10 million	162	3	$0.8 bil.	69,664
< $1 million	782	30	$0.02 bil.	13,976
Total	13,299	359	$84,621 bil.	41,081,750

Table 4, Panel B: Retail Registered Investment Advisers (RIAs) as of December 2018

Cumulative RIA AUM and Accounts

Size of Investment Adviser (AUM)	Num. of RIAs	Num. of Dually registered RIAs	Cumulative AUM	Cumulative Number of Accounts
> $50 billion	119	14	$30,291 bil.	20,592,326
$1 billion to $50 billion	1,614	111	$9,570 bil.	13,224,188
$500 million to $1 billion	1,007	44	$700 bil.	1,392,842
$100 million to $500 million	4,548	113	$1,026 bil.	5,287,584
$10 million to $100 million	706	23	$40 bil.	308,285
$1 million to $10 million	102	3	$0.5 bil.	69,534
< $1 million	169	10	$0.02 bil.	13,946
Total IAs[924]	8,235	318	$41,434 bil.	40,887,325

In addition to SEC-registered investment advisers, other investment advisers are registered with state regulators.[925] As of December 2018, there are 17,268 state-registered

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924 Total IAs includes all retail-facing investment advisers, including those dual-registrants that have retail-facing SEC-registered broker-dealers and SEC-registered investment advisers.

925 Item 2.A. of Part 1A of Form ADV and Advisers Act rules 203A-1 and 203A-2 require an investment adviser to register with the SEC if it (1) is a large adviser that has $100

investment advisers,[926] of which 125 are also registered with the Commission. Of the state-registered investment advisers, 204 are dually registered as broker-dealers, while approximately 4.6% (786) report a broker-dealer affiliate. In aggregate, state-registered investment advisers have approximately $334 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 63% for Commission-registered investment advisers.

Approximately 81% of state-registered investment advisers (13,927) have some portion of their business dedicated to retail investors,[927] and in aggregate, these firms have

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million or more of regulatory AUM (or $90 million or more if an adviser is filing its most recent annual updating amendment and is already registered with the SEC); (2) is a mid-sized adviser that does not meet the criteria for state registration or is not subject to examination; (3) meets the requirements for one or more of the revised exemptive rules under section 203A; (4) is an adviser (or subadviser) to a registered investment company; (5) is an adviser to a business development company and has at least $25 million of regulatory AUM; or (6) receives 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 to provide a buffer for mid-sized advisers with AUM close to $100 million to determine whether and when to switch between state and Commission registration. Advisers Act rule 203A-1(a).

926 There are 70 investment advisers with latest reported regulatory AUM in excess of $110 million but that are not listed as registered with the SEC. None of these 70 investment advisers has exempted status with the Commission. For the purposes of this rulemaking, these are considered potentially erroneous submissions.

927 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. 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.

approximately $324 billion in AUM.[928] Approximately 13,910 (81%) state-registered advisers serve 14 million non-high net worth retail clients and have approximately $137 billion in AUM, while over 11,497 (67%) state-registered advisers serve approximately 170,000 high net worth retail clients with $169 billion in AUM.[929]

c. Trends in the Relative Numbers of Providers of Financial Services

Over time, the relative number of broker-dealers and investment advisers has changed. Figure 1 presented below shows the time series trend of growth in broker-dealers and SEC-registered investment advisers between 2005 and 2018. Over the last 14 years, the number of broker-dealers has declined from over 6,000 in 2005 to less than 4,000 in 2018, while the number of investment advisers has increased from approximately 9,000 in 2005 to over 13,000 in 2018. This change in the relative numbers of broker-dealers and investment advisers over time likely is a reflection of the market for investment advice, and potentially of the choices available to retail investors regarding how to receive or pay for such advice, the nature of the advice, and the attendant conflicts of interest.

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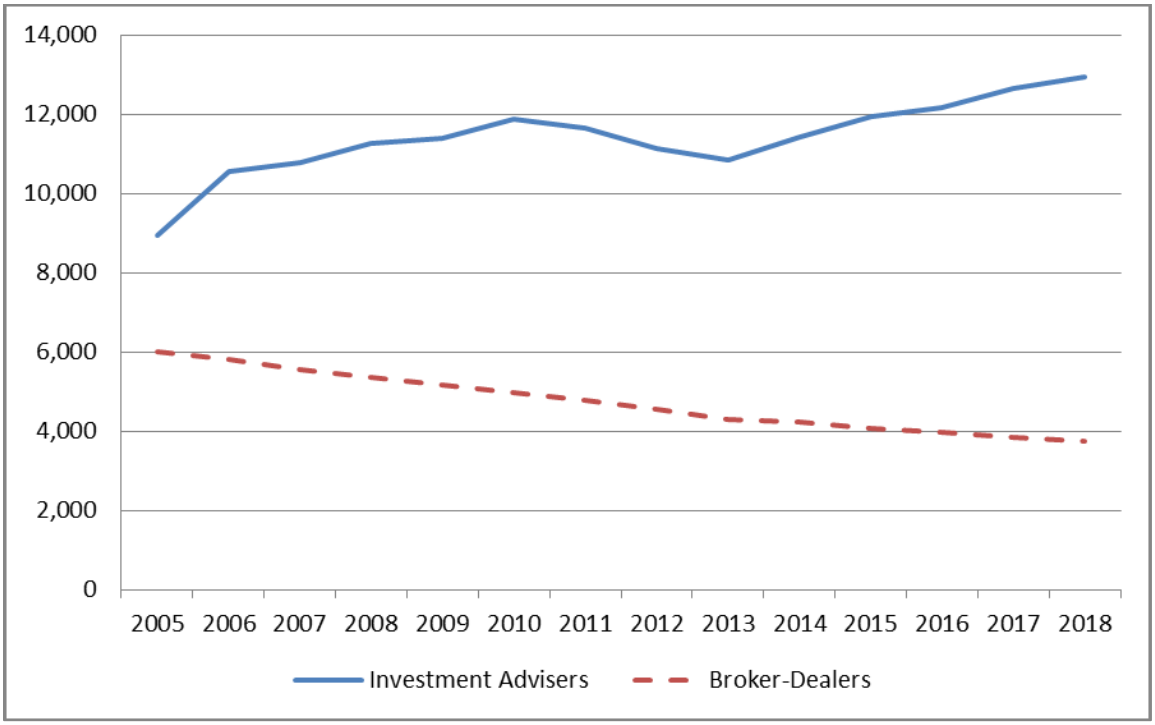
928 The aggregate AUM reported for these investment advisers that have retail investors includes both retail AUM as well as any institutional AUM also held at these advisers.

929 Estimates are based on IARD system data as of February 10, 2018. The AUM reported here is specifically that of those non-high net worth investors. Of the 13,927 state-registered investment advisers serving retail investors, 134 may also be dually registered as broker-dealers.

Figure 1: Time Series of the Number of SEC-Registered Investment Advisers and Broker-Dealers (2005 – 2018)



Increases in the number of investment advisers and decreases in the number of broker-dealers could have occurred for a number of reasons, including changes in regulation and the enforcement of regulation, anticipation of possible regulatory changes, technological innovation (e.g., the increase in automated advisers, which are often colloquially referred to as "robo-advisors" and online trading platforms), product proliferation (e.g., index mutual funds and exchange-traded products), and industry consolidation driven by economic and market

conditions, particularly among broker-dealers.[930] Commission staff has observed the transition by broker-dealers from traditional brokerage services to also providing 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 because they provide a more steady source of revenue than accounts that charge commissions and are dependent on transactions.[931] Broker-dealers have indicated that the following factors have contributed to this

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930 *See* Hester Peirce, *Dwindling Numbers in the Financial Industry*, Brookings Center on Markets and Regulation Report (May 15, 2017), *available at* https://www.brookings.edu/research/dwindling-numbers-in-the-financial-industry/ ("Brookings Report"), which notes 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, other SROs, National Futures Association ("NFA"), or the Municipal Securities Rulemaking Board ("MSRB").

931 Beyond Commission observations, the Brookings Report, *supra* footnote 930, also discusses the shift from broker-dealer to investment advisory business models for retail investors, in part due to the DOL Fiduciary Rule. Declining transaction-based revenue due to declining commission rates and competition from discount brokerage firms has made fee-based securities and services more attractive to providers of such securities and services. 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 steady stream of revenue regardless of the customer trading activity, unlike commission-based accounts. *See also* Angela A. Hung, et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,* RAND Institute for Civil Justice Technical Report (2008), *available at* https://www.rand.org/content/dam/rand/pubs/technical_reports/2008/RAND_TR556.pdf ("2008 RAND Study"), which discusses a shift from transaction-based to fee-based brokerage accounts prior to recent regulatory changes.

migration: provision of revenue stability or increase in profitability,[932] perceived lower regulatory burden, and provisions of more services to retail customers.[933] Some firms have reported record profits as a result of moving clients into fee-based accounts, and cite that it provides "stability and high returns."[934]

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[932] 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 3/14/2019 Form 10-K *available at* https://www.sec.gov/Archives/edgar/data/815917/000156459019007788/ck0000815917-10k_20181231.htm; Raymond James 11/21/2018 Form 10-K *available at* https://www.sec.gov/Archives/edgar/data/720005/000072000518000083/rjf-20180930x10k.htm; Stifel 2/20/2019 Form 10-K *available at* https://www.sec.gov/Archives/edgar/data/720672/000156459019003474/sf-10k_20181231.htm; Wells Fargo 2/27/2019 10-K *available at* https://www.sec.gov/Archives/edgar/data/72971/000007297119000227/wfc-12312018x10k.htm; and Ameriprise 2/23/2018 Form 10-K *available at* https://www.sec.gov/Archives/edgar/data/820027/000082002718000008/amp12312017.htm. We note that discussions in Form 10-K and 10-Q filings of this sample of broker-dealers here may not be representative of other large broker-dealers or of small to mid-size broker-dealers.

[933] *See infra* Section III.B.2.e.ii, which discusses industry trends, particularly in response to the DOL Fiduciary Rule.

[934] *See* Hugh Son, *Morgan Stanley Wealth-Management Fees Climb to All-Time High*, BLOOMBERG, Jan. 18, 2018, 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. *See* Morgan Stanley Strategic Update (Jan. 18, 2018), *available at* https://www.morganstanley.com/about-us-ir/shareholder/4q2017-strategic-update.pdf. *See also* Lisa Beilfuss & Brian Hershberg, *WSJ Wealth Adviser Briefing: The Reinvention of Morgan and Merrill, Adviser Profile*, WALL ST. J., Jan. 25, 2018,

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, it increased by more than 12 million new non-high net worth retail clients between 2012 and 2017, and has declined since 2017. With respect to AUM, 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 and there also has been leveling and subsequent reduction in AUM for non-high net worth retail clients over a similar time period.

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https://blogs.wsj.com/moneybeat/2018/01/25/wsj-wealth-adviser-briefing-the-reinvention-of-morgan-and-merrill-adviser-profile/.

Figure 2: Time Series of the Number of Retail Clients of Investment Advisers (2010 – 2018)

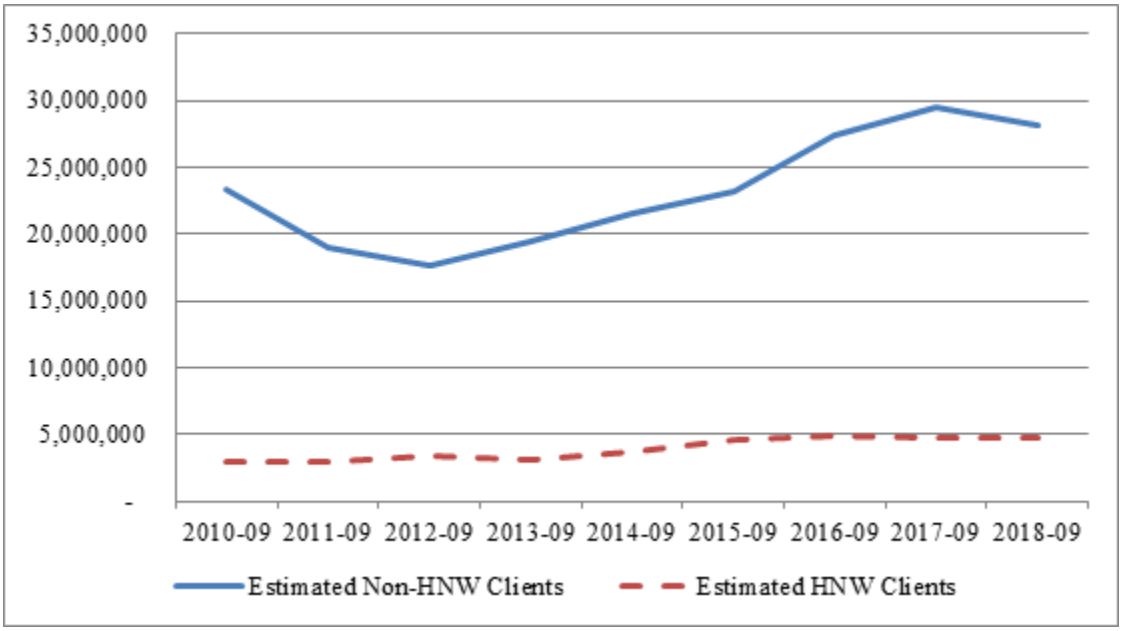
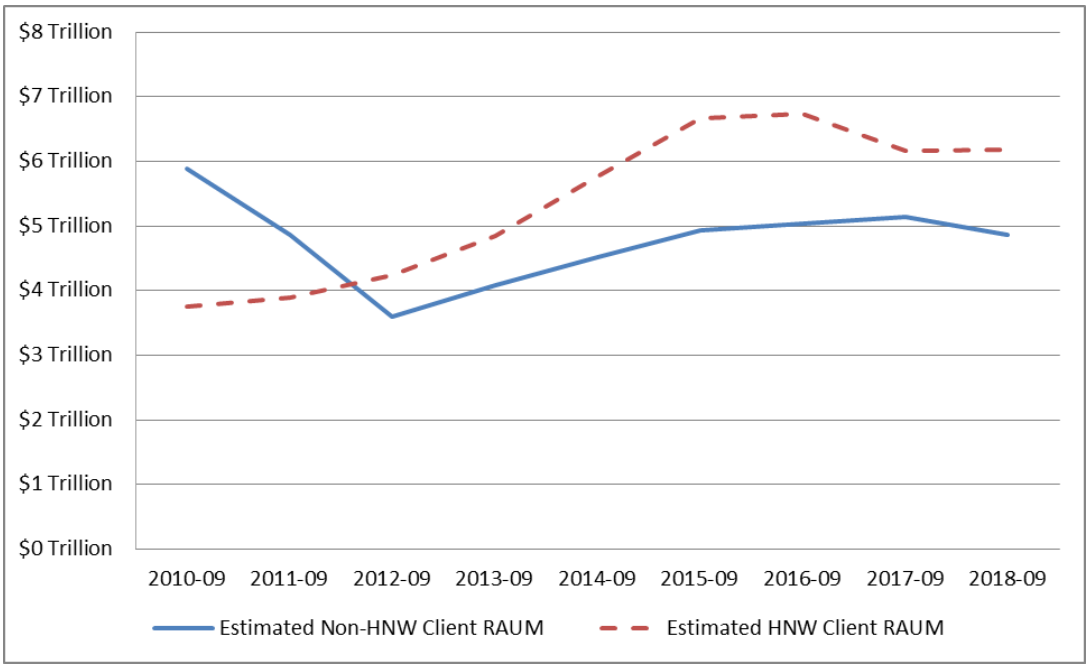


Figure 3: Time Series of the Retail Clients of Investment Advisers AUM (2010 – 2018)



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").[935] 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.[936]

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935 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 with FINRA. Therefore, 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.

936 *See* Advisers Act, [17 CFR §275.203A-3 (2019)]. 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 to retail investors 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 that meet the definition of "qualified client." In addition, state securities authorities may impose different criteria for requiring registration as an investment adviser representative.

We estimate the number of registered representatives and registered IARs, including dually -registered representatives, (together "registered financial professionals") 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 registered representative or investment adviser representative.[937] We only consider employees at firms who have retail-facing business, as defined previously.[938] We observe in Table 5 that approximately 60% 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, 67% of all registered financial professionals in that size category are employed by dually registered firms. Focusing on dually registered firms only, approximately 60.5% of total registered financial professionals at these firms are dually registered representatives; approximately 39.1% are only registered representatives; and less than one percent are only registered investment adviser representatives.

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937 We calculate these numbers based on Form U4 filings. Representatives of broker-dealers, investment advisers, and issuers of securities must file this form when applying to become registered in appropriate jurisdictions and with SROs. Firms and representatives have an obligation to amend and update information as changes occur. Using the examination information contained in the form, we consider an employee a registered financial professional if he or she has an approved, pending, or temporary registration status for either Series 6 or 7 (registered representative) or is registered as an investment adviser representative in any state or U.S. territory (IAR). We limit the firms to only those that do business with retail investors, and only to licenses specifically required as a registered representative or IAR.

938 *See supra* footnotes 900 and 927.

Table 5: Total Registered Representatives at Broker-Dealers, Investment Advisers, and Dually Registered Firms with Retail Investors[939]

Size of Firm (Total Assets for Standalone BDs and Dually Registered Firms; AUM for Standalone IAs)	Total Number of Reps	% of Reps in Dually Registered Firms	% of Reps in Standalone BD w/ an IA Affiliate	% of Reps in Standalone BD w/o an IA Affiliate	% of Reps in Standalone IA w/ a BD Affiliate	% Reps in Standalone IA w/o a BD Affiliate
>$50 billion	84,461	73%	7%	0%	19%	1%
$1 billion to $50 billion	170,256	67%	11%	0%	15%	7%
$500 million to $1 billion	29,874	71%	5%	1%	7%	16%
$100 million to $500 million	66,924	51%	27%	0%	4%	18%
$10 million to $100 million	106,178	55%	42%	2%	1%	1%
$1 million to $10 million	33,790	35%	54%	11%	0%	0%
< $1 million	12,522	8%	52%	36%	3%	1%
Total Licensed Representatives	504,005	60%	23%	2%	9%	6%

939 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.

In Table 6 below, we estimate the number of employees who are registered representatives, registered investment adviser representatives, or dually registered representatives.[940] 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.[941]

In Table 6, approximately 25% of registered employees at registered broker-dealers or investment advisers are dually registered representatives. However, this proportion varies significantly across size categories. For example, for firms with total assets between $1 billion and $50 billion,[942] approximately 35% of all registered employees are dually registered representatives. In contrast, for firms with total assets below $1 million, 13% of all employees are dually registered representatives.

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940 We calculate these numbers based on Form U4 filings.

941 *See supra* footnotes 900 and 927.

942 Firm size is defined as total assets from the balance sheet for broker-dealers and dual-registrants (source: FOCUS reports) and as AUM 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 AUM, 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[943]

Size of Firm (Total Assets for Standalone BDs and Dually Registered Firms; AUM for Standalone IAs)	Total Number of Employees	Percentage of Dually Registered Representatives	Percentage of Registered Representatives Only	Percentages of IARs Only
>$50 billion	218,539	19%	16%	1%
$1 billion to $50 billion	328,842	35%	12%	4%
$500 million to $1 billion	43,211	18%	40%	10%
$100 million to $500 million	119,214	23%	24%	9%
$10 million to $100 million	176,559	20%	39%	1%
$1 million to $10 million	56,230	17%	39%	1%
< $1 million	18,334	13%	46%	3%
Total Employees at Retail-Facing Firms	960,929	25%	23%	4%

Approximately 87% of investment adviser representatives are dually 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.[944] In contrast, approximately 52% of registered representatives were dually registered as investment adviser representatives at the end of 2018.[945]

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943 *See supra* footnotes 899, 920, 940, and 942. Note that all percentages in the table have been rounded to the nearest whole percentage point.

944 *See* Letter from Angela C. Goelzer, FINRA, to Jennifer B. McHugh, Senior Advisor to the Chairman, U.S. Securities and Exchange Commission, re: File Number 4-606;

e. Investor Account Statistics

Investors seek financial advice and services to achieve a number of different goals, such as saving for retirement or children's college education. Approximately 73% of adults live in a household that invests.[946] The OIAD/RAND survey indicates that non-investors are more likely to be female, to have lower family income and educational attainment, and to be younger than investors.[947] Approximately 35% of households that do invest do so through accounts such as broker-dealer or advisory accounts.[948]

As shown above in Figures 2 and 3, the number of retail investors and their AUM associated with investment advisers has increased significantly, particularly since 2012. As of

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Obligations of Brokers, Dealers and Investment Advisers (Nov. 3, 2010), at 1, *available at* https://www.sec.gov/comments/4-606/4606-2836.pdf.

945 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.

946 *See* OIAD/RAND, defining "investors" as persons "owning at least one type of investment account, (e.g., an employer-sponsored retirement account, a non-employer sponsored retirement account such as an IRA, a college savings investment account, or some other type of investment account such as a brokerage or advisory account), or owning at least one type of investment asset (e.g., mutual funds, exchange-traded funds or other funds; individual stocks; individual bonds; derivatives; and annuities)."

947 *Id.* at 36.

948 *Id.* at 39.

December 2016, nearly $24.2 trillion is invested in retirement accounts, of which $7.5 trillion is in IRAs.[949] A total of 43.3 million U.S. households have either an IRA or a brokerage account; an estimated 20.2 million U.S. households have a brokerage account, and 37.7 million households have an IRA (including 72% of households that also hold a brokerage account).[950] With respect to IRA accounts, one commenter documents that 43 million U.S. households own either traditional or Roth IRAs and that approximately 70% are held with financial professionals, with the remainder being direct market.[951] Further, this commenter finds that approximately 64% of households have aggregate IRA (traditional and Roth) balances of less than $100,000, and approximately 36% of investors have balances below $25,000. As noted in one study, the growth of assets in traditional IRAs comes from rollovers from workplace retirement plans; for

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949 *See* Sarah Holden & Daniel Schrass, *The Role of IRAs in U.S. Households' Saving for Retirement, 2016*, ICI RES. PERSP., Jan. 2017, *available at* https://www.ici.org/pdf/per17-08.pdf. *See also* ICI Letter.

950 The data is obtained from the Federal Reserve System's 2016 Survey of Consumer Finances ("SCF Survey"), a triennial survey of approximately 6,200 U.S. households, and imputes weights to extrapolate the results to the entire U.S. population. As noted, some survey respondent households have both a brokerage and an IRA. *See* Board of Governors of the Federal Reserve System, *Survey of Consumer Finances* (2016), *available at* https://www.federalreserve.gov/econres/scfindex.htm. The SCF Survey data does not directly examine the incidence of households that could use advisory accounts instead of brokerage accounts; however, some fraction of IRA accounts reported in the survey could be those held at investment advisers.

951 *See* Sarah Holden & Daniel Schrass, *The Role of IRAs in US Households' Saving for Retirement, 2018*, ICI RES. PERSP., Dec. 2018, *available at* https://www.ici.org/pdf/per24-10.pdf. *See also* ICI Letter.

example, 58% of traditional IRAs consist of rollover assets, and contributions due to rollovers exceeded $460 billion in 2015 (the most recently available data).[952]

While the number of retail investors obtaining services from investment advisers and the aggregate value of associated AUM has increased, the OIAD/RAND study also suggests that the general willingness of investors to use planning or to take financial advice regarding strategies, securities, or accounts is relatively fixed over time.[953] With respect to the account assets associated with retail investors, the OIAD/RAND survey also estimates that approximately 10% of investors who have brokerage or advisory accounts hold more than $500,000 in assets, while approximately 47% hold $50,000 in assets or less. Altogether, investors who have brokerage or advisory accounts typically trade infrequently, with approximately 31% reporting no annual transactions and an additional approximately 30% reporting three or fewer transactions per year.[954]

With respect to particular securities, commenters have provided us with additional information about ownership of mutual funds and IRA account statistics. For example, one commenter stated that 56 million U.S. households and nearly 100 million individual investors own mutual funds, of which 80% are held through 401(k) and other work-based retirement plans,

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952 *See* Holden & Schrass (2018), *supra* footnote 951.

953 *See* OIAD/RAND at 50 (noting that this conclusion was limited by the methodology of comparing participants in a 2007 survey with those surveyed in 2018).

954 *See* OIAD/RAND.

while 63% of investors hold mutual funds outside of those plans.[955] Of those investors who own mutual funds outside of workplace retirement plans, approximately 50% use financial professionals, while nearly one-third purchase direct-sold funds either directly from the fund company or through a discount broker.[956]

Table 7 below provides an overview of account ownership segmented by account type (e.g., IRA, brokerage, or both) and investor income category based on the SCF Survey.[957]

Table 7: Ownership by Account Type in the U.S. by Income Group

(as reported by the 2016 SCF Survey)

Income Category	% Brokerage Only	% IRA Only	% Both Brokerage and IRA
Bottom 25%	1.2%	7.6%	2.4%
25% - 50%	3.2%	14.5%	5.4%
50% - 75%	4.1%	21.4%	11.4%
75% - 90%	7.5%	33.4%	16.5%
Top 10%	12.0%	24.7%	43.9%
Average	4.4%	18.3%	11.6%

955 *See* ICI Letter; *see also* Sarah Holden, Daniel Schrass, & Michael Bogdan, *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2018*, ICI RES. PERSP., Nov. 2018, *available at* https://www.ici.org/pdf/per22-06.pdf.

956 *See* Holden et al. (2018), *supra* footnote 955. *See also* ICI Letter.

957 *See* SCF Survey, *supra* footnote 950. To the extent that investors have IRA accounts at banks that are not also registered as broker-dealers, our data may overestimate the numbers of IRA accounts held by retail investors that could be subject to Regulation Best Interest.

With respect to the nature of the accounts held by investors and whether they are managed by financial professionals, the OIAD/RAND survey finds that 36% of its sample of participants report that they currently use a financial professional and approximately 33% receive some kind of recommendation service.[958] Of the subset of those investors who report holding a brokerage, advisory, or similar account, approximately 33% self-direct their own account, 25% have their account managed by a financial professional, and 10% have their account advised by a financial professional.[959] For those investors who take financial advice, the OIAD/RAND study suggests that they may differ in characteristics from other investors. The survey further finds that investors who take financial advice are generally older, retired, and have a higher income than other investors, but also may have lower educational attainment (e.g., high school or less) than other investors.[960]

Similarly, one question in the SCF Survey asks what sources of information households' financial decision-makers use when making decisions about savings and investments. Respondents can list up to fifteen possible sources from a preset list that includes "Broker" or "Financial Planner" as well as "Banker," "Lawyer," "Accountant," and a list of non-professional

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958 *See* OIAD/RAND at 48. In a focus group preceding the survey, focus group participants provided a number of reasons for not using a financial professional in making investments, including being unable or unwilling to pay the fees, doing their own financial research, being unsure of how to work with a professional, and being concerned about professionals selling securities without attending to investors' plans and goals.

959 *See* OIAD/RAND at 46.

960 *See* OIAD/RAND at 48.

sources.[961] Panel A of Table 8 below presents the breakdown of where households who have brokerage accounts seek advice about savings and investments. The table shows that of those respondents with brokerage accounts, 23% (4.7 million households) use advice services of broker-dealers for savings and investment decisions, while 49% (7.8 million households) take advice from a "financial planner." Approximately 36% (7.2 million households) seek advice from other sources such as bankers, accountants, and lawyers. Almost 25% (5.0 million households) do not use advice from the above sources.

Panel B of Table 8 below presents the breakdown of advice received by households who have an IRA. Approximately 15% (5.7 million households) rely on advice services of their broker-dealers and 48% (18.3 million households) obtain advice from financial planners. Approximately 41% (15.5 million households) seek advice from bankers, accountants, or lawyers, while the 25% (9.5 million households) use no advice or seek advice from other sources.

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961 *See* SCF Survey, *supra* footnote 950, which specifically asks participants "Do you get advice from a friend, relative, lawyer, accountant, banker, broker, or financial planner? Or do you do something else?" *See* Federal Reserve Codebook for 2016 Survey of Consumer Finances (2016), *available at* https://www.federalreserve.gov/econres/files/codebk2016.txt. Other response choices presented by the survey include "Calling Around," "Magazines," "Self," "Past Experience," "Telemarketer," and "Insurance Agent," as well as other choices. Respondents could also choose "Do Not Save/Invest." The SCF Survey allows for multiple responses, so these categories are not mutually exclusive. However, we would note that the list of terms in the question does not specifically include "investment adviser."

Table 8, Panel A: Sources of Advice for Households who have a Brokerage Account in the U.S. by Income Group[962]

Income Category	% Taking Advice from Brokers	% Taking Advice from Financial Planners	% Taking Advice from Lawyers, Bankers, or Accountants	% Taking no Advice or from Other Sources
Bottom 25%	20.55%	53.89%	35.64%	24.30%
25% - 50%	22.98%	38.03%	43.92%	32.36%
50% - 75%	20.75%	52.00%	31.42%	23.61%
75% - 90%	22.56%	48.94%	32.25%	28.10%
Top 10%	25.29%	50.53%	38.47%	21.06%
Average	23.02%	49.02%	35.99%	24.94%

Table 8, Panel B: Sources of Advice for Households who have an IRA in the U.S. by Income Group[963]

Income Category	% Taking Advice from Brokers	% Taking Advice from Financial Planners	% Taking Advice from Bankers, Accountants, or Lawyers	% Taking no Advice or from Other Sources
Bottom 25%	12.14%	38.30%	43.69%	31.85%
25% - 50%	9.79%	43.82%	40.67%	32.74%
50% - 75%	14.93%	45.20%	41.23%	25.23%
75% - 90%	14.68%	52.14%	41.65%	24.26%
Top 10%	21.40%	55.40%	40.03%	18.56%
Average	15.25%	48.45%	41.17%	25.28%

962 *See* SCF Survey, *supra* footnote 950.

963 *Id.*

The OIAD/RAND survey notes that for survey participants who reported working with a specific individual for investment advice, 70% work with a dual-registrant, 5.4% with a broker-dealer, and 5.1% with an investment adviser.[964]

f. 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 financial professionals.[965] While some firms provide base pay for their financial professionals ranging from approximately $45,000 to $85,000 per year, many firms provide compensation only through a percentage of commissions, plus performance-based awards, such as individual or team bonuses based on production.[966] Commission-based compensation to financial professionals range from 30% to 95% of total commissions paid to the firm on a particular transaction, although this compensation is generally reduced by various costs and expenses attributable to the financial professional (e.g., clearing costs associated with some securities,

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964 *See* OIAD/RAND at 53. As documented by OIAD/RAND, retail investors surveyed had difficulty in accurately identifying the type of relationship that they have with their financial professional.

965 Information on compensation and financial incentives generally relates to 2016 compensation arrangements for a sample of approximately 20 firms, comprising 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 securities offered by standalone broker-dealers and dually registered firms.

966 Commission experience indicates that some firms award production bonuses based on commissions generated, while other firms provide awards based on AUM.

charges related to an SRO or the Securities Investor Protection Corporation ("SIPC"), and insurance, among others).

Several firms have varying commission-based compensation rates depending on the investment type being sold. For example, compensation ranges from 76.5% for stocks, bonds, options, and commodities to 90% for open-ended mutual funds, private placements, and unit investment trusts. Several firms charge varying commissions on securities depending on the amount of security sold (e.g., rates on certain proprietary mutual funds range from 0.75% to 5.75% depending on the share class), but do not provide those rates to financial professionals based on investment type. Some firms also provide incentives for their financial professionals to recommend proprietary securities and services over third-party or non-proprietary securities. Commission rates for some firms, however, decline as the dollar amount sold increases, and such rates vary across asset classes as well (e.g., within a given share class, rates range from 1.50% to 5.75% depending on the dollar amount of the fund sold). With respect to compensation to individual financial professionals, if compensation rates for mutual funds are approximately 90% (as discussed above, for example), financial professionals can earn between 0.68% and 5.18%, depending on the type and amount of security sold.

For financial professionals who do not earn commission-based compensation, some firms charge retail customers flat fees ranging from $500 to $2,500, depending on the level of service required, such as financial planning, while others charge hourly rates ranging from $150 to $350 per hour. For dually registered firms that charge clients based on a percentage of AUM, the average percentage charge varies based on the size of the account: the larger the AUM, the lower the percentage fee charged. Percentage-based fees for the sample firms range from approximately 1.5% for accounts below $250,000 to 0.5% for accounts in excess of $1

million.[967] If compensation rates range between 30% and 95%, a firm charging a customer $500 can provide compensation to the financial professional between $150 and $475 for each financial plan provided. For fee-based accounts, assuming that a retail customer has an account worth $250,000, the firm will charge account-level fees of $3,750 ($250,000 x 1.5%), and the financial professional can earn between $1,170 and $3,560 annually for each account. However, accounts may also be subject to additional fees beyond those described here and the financial professionals also may receive additional compensation.

In addition to "base" compensation, most firms also provide bonuses (based on either individual or team performance) or variable compensation, ranging from approximately 10% to 83% of base compensation. These bonuses could be awarded based on either commissions generated or AUM. While the majority of firms base at least some portion of their bonuses on production, usually in the form of total gross revenue, other forms of bonus compensation are

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[967] We note that some firms could have higher or lower commission-based compensation 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* AdvisoryHQ, *Average Financial Advisor Fees in 2018-2019: Fees Charged by Advisory & Wealth Management Firms*, 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.

derived from customer retention, customer experience, and manager assessment of performance. Moreover, some firms use a tiered system within their compensation grids depending on firm experience and production levels. Financial professionals' variable compensation can also increase when they enroll retail customers in advisory accounts versus other types of accounts, such as brokerage accounts. Some firms also provide transition bonuses for financial professionals with prior work experience based on historical trailing production levels and AUM. Although many firms do not have any incentive-based contests or programs, some firms award 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.[968]

2. Regulatory Baseline and Current Market Practices

Broker-dealers' current standards of conduct are governed by federal and state law and regulation as well as the rules and guidance of SROs,[969] particularly, for the purposes of this

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968 *See* FINRA Regulatory Notice 16-29, Gifts, Gratuities and Non-Cash Compensation Rules – FINRA Requests Comment on Proposed Amendments to Its Gifts, Gratuities and Non-Cash Compensation Rules (Aug. 2016). At the time this notice was published, FINRA's impression was that investment-specific internal sales contests for non-cash compensation were not widely used.

969 Generally, all registered broker-dealers that deal with the public must become members of 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

rulemaking, those related to the suitability of recommendations and disclosure of conflicts of interest. In response to comment letters that stated the Proposing Release did not fully consider the current market practices, we have provided an overview of these practices reported by commenters and from industry studies.[970] Together, these laws and regulations comprise the regulatory baseline.

a. Federal and State Securities Laws

Under the antifraud provisions of the federal securities laws and SRO rules, broker-dealers are required to deal fairly with their customers.[971] In addition, broker-dealers must comply with a wide range of specific obligations specified in the Exchange Act and the rules thereunder. Moreover, there is a body of case law holding that broker-dealers that exercise

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regulatory requirements when providing advice, we focus on FINRA's regulation, examination, and enforcement with respect to member broker-dealers.

970 *See, e.g.*, AALU Letter; Letter from John L. Thornton, Co-Chair, Committee in Capital Markets Regulation (Jul. 18, 2018) ("CCMR Letter"); CFA August 2018 Letter; Davis & Harman Letter; EPI Letter; Lincoln Financial Letter; NASAA August 2018 Letter; UVA Letter (which stated that the Proposing Release did not adequately address current market practices and/or provide industry studies and surveys of those practices).

971 *See, e.g.*, FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade); NASD Interpretive Material 2310-2, Fair Dealing with Customers ("Implicit in all member and registered representative 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."); *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944); *Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969); *see also e.g.*, 913 Study at 51 and footnote 221.

discretion or control over customer assets, or have a relationship of trust and confidence with their customers, may owe customers a fiduciary duty, depending on the circumstances.[972] Additionally, some states provide through statute or regulation, among other requirements such as minimum requirements for sales practices, that broker-dealers have some form of state-specific fiduciary duty to their customers in at least some circumstances. Substantial variation exists among states' fiduciary standards, ranging from states with express fiduciary standards that apply to broker-dealers to those with limited or no such standards.[973]

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[972] *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). *See also* Gross Letter (which discussed the obligations of broker-dealers with discretionary or de facto control over customer accounts); Solely Incidental Interpretation.

[973] *See* AARP August 2018 Letter; PIABA Letter; U. of Miami Letter. *See also* Michael S. Finke & Thomas Patrick Langdon, *The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice* (Working Paper, Mar. 9, 2012) for a discussion of state fiduciary standards. One comment letter also provided an extensive overview of the fiduciary

b. FINRA Rule 2111: Suitability

FINRA Rule 2111 (the "Suitability Rule") requires that a broker-dealer or associated person have a reasonable basis to believe that a recommended securities transaction or investment strategy involving securities is suitable for the retail customer.[974] A broker-dealer cannot disclaim away its suitability obligation under the Suitability Rule.[975] We reviewed the Suitability Rule and drew upon it and enhanced the suitability requirement in developing Regulation Best Interest.[976] FINRA also requires additional specific suitability obligations with

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obligations of state-registered investment advisers, "typified by an expectation of undivided loyalty where the adviser acts primarily for the benefit of its clients." *See* NASAA February 2019 Letter at 22 and footnote 40. This comment letter also stated that "[s]ome states also extend these fiduciary obligations beyond investment advisers to brokers, especially in dual-hatted scenarios," and that these fiduciary obligations were extended even when broker-dealers handled non-discretionary accounts. *Id.* at 23-24 and footnote 41.

974 *See* FINRA Rule 2111, *supra* footnote 161. As a "General Principle," the rule states that associated persons have a "fundamental responsibility for fair dealing" and that the rule is intended to promote ethical sales practices and high standards of commercial conduct. *See* FINRA Rule 2111.01. *See also*, *In re Application of Raghavan Sathianathan*, Exchange Act Release No. 54722 at 10 (Nov. 8, 2006) ("Sathianathan's recommendations… were unsuitable because they were designed to maximize his own commissions rather than to establish a suitable portfolio."). *See also* 913 Study at 59 and footnote 187.

975 FINRA Rule 2111.02 (Disclaimers).

976 *See supra* footnote 161. The primary requirements for the Suitability Rule are described in the Proposing Release at Section IV.B.2.a.

respect to certain types of securities or transactions, such as variable insurance products and derivatives securities, including options and securities-based futures.[977]

As discussed by several commenters,[978] the regulatory baseline also includes FINRA guidance on best practices, such as guidance regarding suitability, which provides guidance on how broker-dealers and associated persons should comply with suitability obligations when making recommendations to customers. FINRA guidance regarding suitability includes Regulatory Notice 12-25, which states that under the Suitability Rule, "a broker's recommendations must be consistent with his customers' best interests,"[979] as well as other regulatory notices that provide guidance on the suitability of specific securities or investment strategies involving securities, including, but not limited to, mutual funds, variable contracts including annuities, structured and complex securities, leveraged and inverse exchange-traded products, and IRA rollovers.[980]

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977 *See, e.g.*, FINRA Rule 2330 (Members' Responsibilities Regarding Deferred Variable Annuities); FINRA Rule 2360 (Options); FINRA Rule 2370 (Securities Futures); FINRA Rule 2821 (Sales Practices for Deferred Variable Annuities including a Suitability Obligation). *See also* 913 Study at 65-66.

978 *See* CFA August 2018 Letter; Bank of America Letter; Transamerica August 2018 Letter.

979 *See* FINRA Regulatory Notice 12-25; *see also* FINRA Regulatory Notice 13-31, Suitability – FINRA Highlights Examination Approaches, Common Findings and Effective Practices for Complying With its Suitability Rules (Sep. 2013) (which provides "…effective practices… to help firms enhance compliance and supervision under the suitability rule").

980 *See*, *e.g.*, NASD Notice to Members 94-16, NASD Reminds Members Of Mutual Fund Sales Practice Obligations (Mar. 1994) and NASD Notice to Members 95-80, NASD

c. FINRA Report on Conflicts of Interest

In 2013, FINRA published as guidance a Report on Conflicts of Interest ("FINRA Conflicts Report") to provide an overview of effective practices that broker-dealers could employ to manage and mitigate conflicts of interest.[981] In the report, FINRA provides suggestions for broker-dealers for addressing conflicts of interest related to three broad areas: a firm-level approach to identify and manage conflicts of interest; the production and distribution of new securities; and compensation and other financial incentives of associated persons.[982]

Further Explains Members Obligations and Responsibilities Regarding Mutual Funds Sales Practices (Sep. 1995) (mutual fund suitability and sales practices); NASD Notice to Members 96-86, NASD Regulation Reminds Members and Associated Persons that Sales of Variable Contracts are Subject to NASD Suitability Requirements (Dec. 1996) and NASD 99-35, NASD Reminds Members of Their Responsibilities Regarding Sales of Variable Annuities (May 1999) (suitability and sales practices of variable contracts and variable annuities); NASD Notice to Members 05-59, NASD Provides Guidance Concerning the Sale of Structure Products; and FINRA Regulatory Notice 12-03, Complex Products – Heightened Supervision of Complex Products (Jan. 2012); (suitability and sales practices of structured and complex products); FINRA Regulatory Notice 09-31, FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds (June 2009) (sales practices of leveraged and inverse ETFs); and FINRA Regulatory Notice 13-45, Rollovers to Individual Retirement Accounts – FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers (Dec. 2013) (obligations when recommending a rollover or transfer of assets from a sponsored retirement plan to an IRA).

981 *See* FINRA Conflicts Report, *supra* footnote 459. *See also* IRI Letter, which notes that the FINRA Conflicts Report "…provides valuable guidance as to the elements of an effective practice framework for managing BDs' conflicts of interest…" *See also* SIFMA August 2018 Letter; CFA August 2018 Letter; Raymond James Letter; Ameriprise Letter; ACLI Letter; Fein Letter.

982 *See* FINRA Conflicts Report, *supra* footnote 459.

With respect to new securities, the FINRA Conflicts Report recommends, among other things, new security review committees and disclosure of conflicts related to recommendations of new securities to customers.[983] The FINRA Conflicts Report also provides guidance to broker-dealers on managing conflicts of interest that arise from compensation and financial incentives of broker-dealers. For example, the FINRA Conflicts Report recommends increased surveillance of recommendations near compensation thresholds and capping compensation credits across similar investment types to prevent representatives from preferentially recommending securities that yield the largest compensation.[984]

d. Other Broker-Dealer Obligations: Disclosure, Supervision, and Compensation

Broker-dealers are subject to other disclosure obligations under the federal securities laws and SRO rules. For instance, under existing antifraud provisions of the Exchange Act, a broker-dealer has a duty to disclose material adverse information to its customers.[985] Broker-dealers

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983 *Id.*

984 *Id.*

985 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 (2nd Cir. 1970); *SEC v. Hasho*, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992); *In the Matter of RichMark Capital Corp.*, Exchange Act Release No. 48758 (Nov. 7, 2003) (Commission Opinion) ("When a securities dealer recommends stock to a customer, it is not only obligated to avoid affirmative misstatements, but also must disclose material adverse facts of which it is aware. That includes disclosure of 'adverse interests' such as 'economic self-interest'

found to be acting as fiduciaries also have a duty to disclose material conflicts of interest.[986] Broker-dealers are also prohibited from making misleading statements.[987] Courts have found that broker-dealers, in making recommendations, 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.[988]

Broker-dealers are also 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

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that could have influenced its recommendation.") (citations omitted). *See also* Relationship Summary Proposal.

986 *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 when engaging in principal transactions, "including her cost of the securities and the best price at which the security might be purchased in the open market").

987 *See* Proposing Release at footnotes 175-177 and 205, and accompanying text. *See* Exchange Act Sections 10(b) and 15(c).

988 *See* 913 Study at footnotes 251-54. *See also id.* at footnotes 225-232 (which discuss existing SRO rules on disclosures).

with, the federal securities laws and regulations, as well as applicable SRO rules.[989] Specifically, the Exchange Act authorizes the Commission to sanction a broker-dealer or any associated person that fails to reasonably supervise another person subject to the firm's or the person's supervision that commits a violation of the federal securities laws.[990] The Exchange Act provides an affirmative defense against a charge of failure to supervise where reasonable procedures and systems for applying the procedures have been established and effectively implemented without reason to believe those procedures and systems are not being complied with. Further, under the federal securities laws and FINRA rules, prices for securities and broker-dealer compensation are required to be fair and reasonable, taking into consideration all relevant circumstances.[991]

Broker-dealers also register with and report information, including about their business and affiliates, to the Commission, the SROs, and other jurisdictions through Form BD.[992] Form BD requires information about the background of the applicant, its principals, controlling

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989 *See supra* footnote 809. *See also* Proposing Release at 21622.

990 Exchange Act Sections 15(b)(4)(E) and (b)(6)(A).

991 *See, e.g.*, Exchange Act Sections 10(b) and 15(c); FINRA Rules 2121 (Fair Prices and Commissions), 2122 (Charges for Services Performed), and 2341 (Investment Company Securities). *See also* FINRA Rule 3221 (Non-Cash Compensation). Several commenters stated that, as part of their overall business practices, they use non-cash compensation (e.g., firm-sponsored business conferences), which they believe is in compliance with existing FINRA Rule 3221 on non-cash compensation practices. *See* Guardian August 2018 Letter; NY Life Letter.

992 *See* Relationship Summary Proposal at 21472; *see also generally* Form BD.

persons, and employees, as well as information about the type of business in which the broker-dealer proposes to engage and all control affiliates engaged in the securities or investment advisory business.[993] Once a broker-dealer is registered, it must keep its Form BD current by amending it promptly when the information is or becomes inaccurate for any reason.[994] In addition, firms report similar information and additional information—such as written customer complaints and other disciplinary matters— to FINRA pursuant to FINRA Rule 4530 (Reporting Requirements).

e. DOL Fiduciary Rule as it Relates to Current Market Practice

This section discusses the recently vacated DOL Fiduciary Rule,[995] the implications for broker-dealers, and the industry response to the DOL Fiduciary Rule. Although the DOL Fiduciary Rule was vacated by the Fifth Circuit Court of Appeals in June, we discuss the DOL Fiduciary Rule as part of the baseline because certain broker-dealers and other industry participants may have adjusted their practices in order to plan for the implementation of the requirements of this rule. It is possible that some of these broker-dealers may continue to operate their business using these adjusted practices, while other may have reverted to the pre-DOL Fiduciary Rule practices. Below, we discuss actual and potential costs, as well as changes

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993 *See generally* Form BD.

994 *See* Exchange Act rule 15b3-1(a).

995 *See supra* footnote 32.

in services and securities offerings, in response to the DOL Fiduciary Rule as reported by industry participants through surveys. We also describe how, following the Fifth Circuit Court of Appeals decision vacating the DOL Fiduciary Rule, certain of those costs have been reduced and the trend toward reduction in retail investor access to services and securities offerings that may have been caused in part by the DOL Fiduciary Rule appears to have ended and may be reversing.

i. Department of Labor's Fiduciary Rule and Temporary Enforcement Policy

As noted above, prior to the Fifth Circuit decision, many firms took steps to come into compliance with the DOL Fiduciary Rule, and in particular, the BIC Exemption and other PTEs, including changes to business practices.[996]

Following the decision by the Fifth Circuit, the DOL acknowledged that uncertainty about fiduciary obligations and the scope of exemptive relief under the prohibited transaction provisions of ERISA and the Internal Revenue Code following the court's decision could temporarily disrupt existing investment advice arrangements during the transition period, and also that financial institutions had devoted significant resources to comply with PTEs issued in connection with the DOL Fiduciary Rule, including the BIC Exemption.[997] Based on these

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996 *See supra* footnotes 32-34 and accompanying text.

997 *See* U.S. Department of Labor Field Assistance Bulletin 2018-02, *available at* https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-02.

concerns, the DOL issued a temporary enforcement policy stating that it would not pursue claims against fiduciaries working in good faith to comply with the BIC Exemption's Impartial Conduct Standards for transactions that would have been exempted by the BIC Exemption or treat such fiduciaries as violating applicable prohibited transactions rules.[998] Prior to the Fifth Circuit decision, some broker-dealers that offered services to IRAs and other retirement accounts may have implemented changes to services and securities to comply with and meet the conditions of the BIC Exemption and other PTEs, including the Impartial Conduct Standards.[999] Although the Commission does not currently have data on the number of firms that may have devoted resources to comply with the PTEs,[1000] the Commission can broadly estimate the maximum number of broker-dealers that could have undertaken changes in order to comply with requirements of the PTEs from the number of broker-dealers that have retail customer accounts.

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998 *Id.*

999 *See, e.g.*, Michael Wursthorn, *A Complete List of Brokers and Their Approach to 'The Fiduciary Rule'*, WALL ST. J., Feb. 6, 2017, https://www.wsj.com/articles/a-complete-list-of-brokers-and-their-approach-to-the-fiduciary-rule-1486413491?mod=article_inline for a discussion of how broker-dealers adjusted certain practices in response to the DOL Fiduciary Rule.

1000 In order to perform this analysis, the Commission would need to know which financial firms offer services to IRAs and other retirement accounts. 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 accounts.

Approximately 73.5% (2,766) of registered broker-dealers report sales to retail customers.[1001] Similarly, approximately 8,235 (62% 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 overestimate the broker-dealers and investment advisers that provide retirement account services and began compliance with the requirements of the PTEs.[1002]

ii. Industry Response to DOL Fiduciary Rule

Although the DOL Fiduciary Rule became effective in June 2017, the DOL provided transitional relief through July 2019,[1003] which is now indefinitely extended under the temporary enforcement policy put in place in June 2018 following the Fifth Circuit decision. As described above, a significant subset of broker-dealers have retail customers with retirement accounts and

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1001 As of December 2018, 3,764 broker-dealers have filed Form BD. Retail sales by broker-dealers were obtained from Form BR. *See supra* footnote 900.

1002 The Department of Labor Regulatory Impact Analysis ("DOL RIA") identifies approximately 4,000 broker-dealers (FINRA, 2016), of which approximately 2,500 are estimated to have either ERISA accounts or IRA accounts serviced by broker-dealers, similar to the estimates that we provide 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 dually registered, approximately 6,000 ERISA plan sponsors (2013 Form 5500 Schedule C), and approximately 400 life insurance companies (2014 SNL Financial Data). *See* U.S. Department of Labor, *Regulating Advice Markets: Definition of the Term 'Fiduciary', Conflicts of Interest, Retirement Investment Advice: 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/ria.pdf.

1003 *See supra* footnote 1002.

would have been affected by the DOL Fiduciary Rule, and at least some broker-dealers began taking steps to effectuate compliance with the DOL Fiduciary Rule. A number of commenters stated that we did not sufficiently consider the existing regulatory environment and the current market practices of firms and financial professionals in light of the DOL's Fiduciary Rule and other existing rules and regulations.[1004] Below, we discuss the industry response to the DOL Fiduciary Rule and the effect of the Fifth Circuit decision on broker-dealers.

In the Proposing Release, we predominantly based our discussion of the industry and customer effects of the DOL Fiduciary Rule on information from a single industry study.[1005] Commenters provided additional citations to industry studies,[1006] which describe changes in market practices across a broader-sample of broker-dealers in response to the DOL Fiduciary Rule.[1007] In these studies, certain of the survey participants reported that they responded to the

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1004 *See, e.g.*, AALU Letter; CCMC Letters; CCMR Letter; CFA August 2018 Letter; Davis & Harman Letter; EPI Letter; Lincoln Financial Letter; Morningstar Letter; NASAA August 2018 Letter; Wells Fargo Letter.

1005 *See* SIFMA Study, *supra* footnote 33. 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, and 27% of qualified retirement savings assets ($4.6 trillion out of $16.9 trillion). The types of retirement accounts serviced by the participants in the SIFMA Study were not defined.

1006 *See, e.g.*, CCMC Letters; Davis & Harman Letter; EPI Letter; Lincoln Financial Letter.

1007 *See, e.g.*, Financial Services Roundtable & Harper Polling, *Department of Labor Fiduciary Rule: National Survey of Financial Professionals* (July 2017), *available at* https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2641320-161289.pdf (*see* Appendix A) ("FSR Study"). The FSR Study surveyed 600 financial advisers in July 2017, including certified financial planners, chartered financial analysts, broker-dealers,

DOL Fiduciary Rule and the BIC Exemption by reducing certain services and access to advice to small retirement accounts. Certain participants further reported that they encouraged customers toward self-directed accounts and/or advisory accounts, including robo-advisors. Certain other participants reported that they reduced or eliminated certain securities within certain types of retirement accounts that they offered. Finally, certain participants reported that they increased certain fees for some of their customers. However, as it is generally the case with survey analysis, the surveys in the aforementioned studies are subject to potential selection biases (i.e., the sample of respondents is not necessarily random) and methodological limitations (e.g., the design of the questionnaire may influence the choices made by the respondents). Given these limitations, it is generally not clear whether the results of these studies capture significant or

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and dually registered representatives. *See also* Center for Capital Markets Competitiveness, *Fiduciary Rule: Initial Impact Analysis*, FTI Consulting Report Presented to the U.S. Chamber of Commerce (Sept. 7, 2017), *available at* https://www.centerforcapitalmarkets.com/wp-content/uploads/2017/07/Fiduciary-Rule-Initial-Impact-Analysis.pdf ("Chamber Study"). The Chamber Study surveyed 14 financial advisory companies (insurance companies, securities manufacturers, and broker-dealers) responsible for $10 trillion in AUM and nearly 26 million investment accounts. The types of accounts serviced by the participants in the Chamber Study were not defined. *See also* A.T. Kearney, *The $20 Billion Impact of the New Fiduciary Rule on the U.S. Wealth Management Industry*, Perspective for Discussion (Oct. 2016), *available at* https://www.atkearney.com/documents/10192/7041991/DOL+Perspective+-+August+2016.pdf/b2a2176b-c821-41d9-b12e-d3d2b0807d69 ("Kearney Study"). We note that the development 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.

marginal changes in broker-dealer practices, and whether these changes are indicative of broader trends in the market for advice in response to the DOL Fiduciary Rule.

Changes to Services and Securities

A number of studies indicated that, as a result of the DOL Fiduciary Rule, certain industry participants had already or were planning to alter their menu of services and securities that they made available to retail customers. For example, of the 21 SIFMA members that participated in the SIFMA Study, 53% eliminated or reduced access to certain brokerage advice services and 67% migrated away from open choice to fee-based or limited brokerage services.[1008] Another study also discussed a shift from commission-based accounts to fee-based accounts but offered no details about the sample or the methodology employed to arrive at the estimates.[1009] Finally, another study documented that at least 29% of their survey participants expected to move clients, particularly those with low account balances, to robo-advisors.[1010] In addition, a number of media articles describe several cases of broker-dealers that have adjusted

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1008 *See* SIFMA Study, *supra* footnote 33.

1009 *See* Kearney Study (provided by the Davis & Harman and Lincoln Financial Letters).

1010 *See* FSR Study, which states that "[a]dvisors who say the average net worth of their clients is under $25,000 are more likely to say they will definitely, probably, or have already directed more clients to robo advisor services, both online and at call centers (43% vs. 29% overall)."

their practices with respect to the range of accounts offered as a result of the DOL Fiduciary Rule.[1011]

Further, industry studies noted that certain of their respondents changed their securities offerings as a result of the DOL Fiduciary Rule.[1012] For example, 95% of the SIFMA Study participants altered their securities offerings by reducing or eliminating certain asset or share classes; 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

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[1011] For example, in response to the DOL Fiduciary Rule, J.P. Morgan and Merrill Lynch phased out commission-based retirement plans and instead charged fees based on AUM. *See* Crystal Kim, *BofA, JPMorgan, and the Fiduciary Rule: Will They or Won't They*, BARRON'S, Mar. 15, 2017, https://www.barrons.com/articles/bofa-jpmorgan-and-the-fiduciary-rule-will-they-or-wont-they-1489588442. However, upon the Fifth Circuit's ruling on the DOL Fiduciary Rule, J.P. Morgan and Merrill Lynch reversed their earlier decision and began to offer commission-based retirement plans again. *See* Jed Horowitz, *JPMorgan to Remove Some Fiduciary Rule Handcuffs, Others May Follow*, ADVISORHUB, May 4, 2018, https://advisorhub.com/jpmorgan-to-remove-some-fiduciary-rule-handcuffs-others-may-follow/; Imani Moise, *Merrill Lynch Does about Face on Fiduciary-Era Policy*, REUTERS, Aug. 30, 2018, https://www.reuters.com/article/us-bank-of-america-fiducuary/merrill-lynch-does-about-face-on-fiduciary-era-policy-idUSKCN1LF1R9. *See also* Daisy Maxey, *Winners and Losers in a Post-Fiduciary World*, WALL ST. J., May 24, 2017, *available at* https://www.wsj.com/articles/winners-and-losers-in-a-post-fiduciary-world-1495638708; Nir Kaissir, *Merrill Lynch Can't Restore the Bad Old Days of Conflicts*, BLOOMBERG, Sept. 4, 2018, *available at* https://www.bloomberg.com/opinion/articles/2018-09-04/merrill-lynch-can-t-restore-the-bad-old-days-of-conflicts.

[1012] While the industry studies discussed in this section examined shifts in services and securities provided to retail investors, one limitation of these studies is that they did not discuss whether the quality of advice provided to retail investors also changed as a result.

annuity securities offerings.[1013] Similarly, another study found that nearly 30% of survey participants eliminated or reduced securities or services available to retirement investors in response to the DOL Fiduciary Rule,[1014] while the Chamber Study noted that 13.4 million accounts of the companies surveyed had limited access to certain securities, including mutual funds, variable annuities, and exchange-traded funds.[1015] Finally, the SIFMA Study states that although the DOL Fiduciary Rule applied only in connection with services for retirement accounts, certain of the survey participants had implemented the changes to both retirement and non-retirement accounts.[1016] These studies do not discuss the attributes of the securities that the participants chose to no longer offer. In addition, as noted above, survey analysis is subject to

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1013 *See* SIFMA Study, *supra* footnote 33.

1014 *See* American Bankers Association, *ABA Survey: Department of Labor Fiduciary Rule* (July 20, 2017), *available at* https://www.aba.com/Advocacy/Issues/Documents/dol-fiduciary-rule-survey-summary-report.pdf ("ABA Study"). The ABA Study conducted a survey of 57 banks about their understanding of the DOL Fiduciary Rule on securities and services available to retirement investors. *See also* Kearney Study, which anticipated a shift from mutual funds to exchange-traded funds, and that "certain high-cost investment products (such as variable annuities) will be phased out as the business model is no longer viable under [the DOL Fiduciary Rule]." *See also* FSR Study, which reported that 63% of its survey participants anticipated fewer investment options and 56% had already reduced or anticipated reducing the number of mutual funds offered to retirement customers.

1015 *See* Chamber Study. *See also* Editorial Board, *Tom Perez's Fiduciary Flop*, WALL ST. J., Mar. 18, 2018, https://www.wsj.com/articles/tom-perezs-fiduciary-flop-1521412228, which noted that some firms restricted sales of commission-based securities such as load mutual funds and variable annuities in retirement accounts.

1016 *See*, *e.g.*, SIFMA Study, *supra* footnote 33.

certain limitations that, generally, complicate the interpretation of their results. For instance, it is not generally clear whether the results of these studies capture significant or marginal changes in broker-dealer practices, and whether these changes are indicative of broader trends in the market for advice in response to the DOL Fiduciary Rule.

Besides the studies mentioned above, a number of media articles provide anecdotal evidence of broker-dealers that chose to no longer offer certain securities.[1017] Some commenters also provided data about historical trends in certain product markets.[1018] For example, one commenter provided data for the market of mutual funds and showed that between 2007 and 2018, the percentage of assets in load mutual funds declined from 27% to 12%, while no-load

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[1017] *See* Alex Steger, *Exclusive: UBS to Cut over 800 Funds from Platform*, CITYWIRE, Mar. 13, 2018, https://citywireusa.com/professional-buyer/news/exclusive-ubs-to-cut-over-800-funds-from-platform/a1100101; Michael Thrasher, *Ameriprise Drops Hundreds of Funds Offered to Brokerage Clients*, WEALTHMANAGEMENT.COM, June 8, 2017, https://www.wealthmanagement.com/industry/ameriprise-drops-hundreds-funds-offered-brokerage-clients; Hugh Son, *Morgan Stanley to Reduce Wealth Fees Even with Rule Uncertainty*, BLOOMBERG, Jan. 26, 2017, https://www.bloomberg.com/news/articles/2017-01-26/morgan-stanley-to-proceed-with-wealth-changes-ahead-of-new-rules; Margarida Correia, *LPL Puts Final Touches on Product Lineups in Preparation for Fiduciary Rule*, FINANCIALPLANNING, Mar. 9, 2017, https://www.financial-planning.com/news/lpl-puts-final-touches-on-product-lineups-in-preparation-for-fiduciary-rule?tag=00000154-3e16-d45e-a175-7f9f48a20001; Bruce Kelly, *Wells Fargo Advisors Restricting Investments for Retirement Accounts*, INVESTMENTNEWS, May 24, 2017, https://www.investmentnews.com/article/20170524/FREE/170529959/wells-fargo-advisors-restricting-investments-for-retirement-accounts.

[1018] *See, e.g.*, ICI Letter.

share classes increased from 51% to 71% over the same time period.[1019] Further, this commenter stated that this shift has occurred because of the growth in assets in 401(k) plans and other retirement accounts, as well as the increase in the number of advisory accounts, both of which tend to invest in no-load share classes.

However, the DOL Fiduciary Rule may have caused certain product markets to adjust.[1020] For example, innovations, including the introduction of T and clean share classes of mutual funds, can be regarded as a paradigm shift in terms of how product sponsors compensate broker-dealers for distribution services. One commenter noted that these products may reduce the expected fund underperformance net of costs for retail investors relative to A shares by nearly 50 basis points annually.[1021]

The Effect of Costs and Fees

Some firms may have responded to the DOL Fiduciary Rule by either presenting customers with the option to enter into different and potentially more costly advice relationships compared to a brokerage advice relationship or by passing some of the compliance costs to

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1019 *See id*.

1020 *See, e.g.*, James Chen, *Clean Shares*, Investopedia, available at https://www.investopedia.com/terms/c/clean-shares.asp, stating that "[t]he mutual fund industry introduced clean shares, along with T shares, in response to the Department of Labor's fiduciary rule."

1021 *See* Letter from Aron Szapiro, Director of Policy Research, Morningstar (Sept. 2017).

customers.[1022] However, one study observed that 63% of the responding firms that limited or eliminated access to advised brokerage services stated that they had at least some customers who chose to move to self-directed accounts rather than fee-based accounts and cited the reasons that customers provided as (1) "did not want to move to a fee-based account," (2) "was not in the retirement investor's best interest to move to a fee-based account," (3) "did not meet the account minimums," or (4) "wished to maintain positions in certain asset classes which were not eligible for a fee-based account."[1023] Another study further observed that nearly 40% of the responding firms believed that the relationship with their customers had been altered as a result of the DOL Fiduciary Rule and that customers with smaller account balances were nearly ten times more likely to have been negatively affected by the DOL Fiduciary Rule than customers with larger account balances.[1024] Further, another study observed that 68% of the responding firms were less likely to provide services to smaller accounts, and 46% anticipated that they may service fewer clients overall.[1025]

1022 *See supra* footnote 1011 (which describes how certain firms responded to the DOL Fiduciary Rule and later reversed changes in response to the Fifth Circuit decision).

1023 *See* SIFMA Study, *supra* footnote 33.

1024 *See* ABA Study.

1025 *See* FSR Study. *See also* Chamber Study, which found that some survey participants have added minimum account balances and have migrated away from commission-based models toward fee-based models.

One study observed that, generally, based on the numbers provided by the respondents, a fee-based account can be more costly than a brokerage account; however, such comparison is generally hard to make without knowing the securities in the two types of accounts, and it is not clear that the survey made this clear to respondents.[1026] One study[1027] observed that approximately 52% of its survey participants indicated that they may pass on the costs associated with complying with the DOL Fiduciary Rule to clients in the form of higher fees, while another study stated that more than 6 million client accounts of the survey participants may be subject to higher costs and fees as a result of the DOL Fiduciary Rule, although it is not clear whether this estimate assumes full adoption of the DOL Fiduciary Rule.[1028]

Estimated Costs of Compliance and Effects on Compensation Structures

One study observed that survey respondents were expecting to incur compliance costs as a result of the DOL Fiduciary Rule that would vary by the size of the respondent.[1029] For

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1026 *See* SIFMA Study. We note that only a subset of the SIFMA Study participants provided information on the costs associated with brokerage and advisory accounts. *See* CFA August 2018 Letter. The SIFMA Study did not provide any information on the set of firms comprised in this subset that provided information on brokerage and advisory costs. *See also* ICI Letter (which provided similar estimates for fees and costs attributable to brokerage and advisory accounts).

1027 *See* FSR Study.

1028 *See* Chamber Study.

1029 *See* SIFMA Study. As a general matter, we note that the estimates reported by industry studies, including this study, are based on a rulemaking with more extensive requirements for changes to business models than those required by Regulation Best Interest.

instance, large firms with net capital in excess of $1 billion were 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 were expected to have start-up and ongoing compliance costs of $16 million and $3 million, respectively. The study further estimated that the total start-up compliance costs for large and medium-size firms combined would have been approximately $4.7 billion, while ongoing costs would have been approximately $700 million per year.

Another study observed that the costs of complying with DOL Fiduciary Rule would encompass technology, legal, process changes, educational, and training costs for firms.[1030] This study forecasted that the DOL Fiduciary Rule may cause a $2 trillion redistribution in assets from broker-dealers to investment advisers, robo-advisors, and self-directed accounts, and a nearly $20 billion decrease in revenues to the entire financial services industry, including broker-dealers.

The study further forecasted that as a result of the DOL Fiduciary Rule product sponsors "will be incentivized to streamline product offerings, lower fees, and improve performance," and investor would pay $7.5 billion less in mutual fund and ETF expenses by the end of 2010. However, as noted above, this study does not provide details about how it obtained its estimates.

Several media articles provide some anecdotal evidence suggesting that as a response to the DOL Fiduciary Rule some broker-dealers began to alter the compensation structures of their

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[1030] *See* Kearney Study.

registered representatives.[1031] For example, some broker-dealers have indicated that they adjusted their compensation structures by equalizing commissions and deferred sales charges across similar securities.[1032] Other broker-dealers banned sales quotas, contests, special awards, and bonuses,[1033] including deferred bonuses as part of recruitment efforts.[1034] However, following the decision by the Fifth Circuit to vacate the DOL Fiduciary Rule, some firms reinstated back-end recruiting bonuses.[1035]

1031 *See* Son (2017), *supra* footnote 1017; Tara Siegel Bernard, *Do Financial Advisers Have to Act in Your Interest? Maybe*, N.Y. TIMES, Mar. 22, 2018, https://www.nytimes.com/2018/03/22/your-money/financial-advisers-customer-interest.html.

1032 *See, e.g.*, Andrew Welsch, *Facing Higher Costs, Raymond James Cuts Adviser Pay in Rare Move*, FINANCIALPLANNING, July 11, 2017, https://onwallstreet.financial-planning.com/news/facing-higher-costs-raymond-james-cuts-adviser-pay-in-rare-move?tag=00000151-16d0-def7-a1db-97f024310000.

1033 *See* Bernard (2018).

1034 *See* Mason Braswell, *Morgan Stanley Resumes Recruiting Offers – Slimmer and DOL-Compliant*, ADVISORHUB, Nov. 3, 2016, https://advisorhub.com/morgan-stanley-resumes-recruiting-offers-slimmer-and-dol-compliant/; Deon Roberts, *Wells Fargo Overhauling Bonuses to Comply with New Rules on Financial Advisers*, CHARLOTTE OBSERVER, Dec. 14, 2016, https://www.charlotteobserver.com/news/business/banking/bank-watch-blog/article120961138.html.

1035 *See* Mason Braswell, *Farewell Fiduciary Rule? Morgan Stanley Sweetens Recruiting Bonuses*, ADVISORHUB, May 1, 2018, https://advisorhub.com/farewell-fiduciary-rule-morgan-stanley-sweetens-recruiting-bonuses/. "Back-end" bonuses are expressly contingent on the achievement of sales or asset targets. *See* U.S. Department of Labor, *Conflict of Interest FAQs (Part I – Exemptions)* (Oct. 27, 2016), *available at* https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-1.pdf.

iii. Additional Evidence of Current Market Practices

In this section, we include information on Commission observations on the broker-dealer industry. Commission experience indicates that there have been a number of changes to the broker-dealer industry and its business practices over time.[1036] Consistent with the trend baseline provided in Section III.B.1.c and industry studies and anecdotal evidence described above, we have observed firms choosing to do business with retail investors as investment advisers, not as broker-dealers, by either migrating existing brokerage accounts to advisory accounts or directing new retail customers to advisory accounts.

Beyond broker-dealer trends in business practices, Commission experience also indicates that some broker-dealers have responded to the DOL Fiduciary Rule and the Fifth Circuit decision vacating the DOL Fiduciary Rule by modifying their existing business practices. For example, some firms, consistent with anecdotal evidence discussed above, eliminated brokerage IRA accounts in response to the DOL Fiduciary Rule; however, upon the Fifth Circuit decision, the firms reinstituted brokerage IRAs. Other examples of changes following the Fifth Circuit

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[1036] Information on the broker-dealer industry and business practices comes from a variety of Commission resources and generally relates to market trends and changes to business practices that have emerged in recent years and is comprised of both standalone broker-dealers and dually registered firms. With respect to industry trends, Commission resources generally verify data cited above in Section III.B.2.e.ii. We acknowledge that the information provided in this baseline may not be representative of business practices more generally because of the diversity and complexity of services and securities offered by standalone broker-dealers and dually registered firms.

decision include changes to incentive-based compensation in certain types of accounts and principal trading restrictions.

3. Investment Advice and Evidence of Potential Investor Harm

A number of commenters expressed the view that the Proposing Release did not fully document the problems attributed to potential conflicts of interest stemming from the broker-dealer model and the resulting harm to retail customers.[1037] In order to address these commenters' concerns, we analyze academic and industry studies to present an overview of the market for advice for retail customers.[1038] Below, we discuss which types of investors seek

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[1037] *See*, *e.g.*, AARP August 2018 Letter; Better Markets August 2018 Letter; CFA August 2018 Letter; EPI Letter; U. of Miami Letter; Morningstar Letter; PIABA Letter; Letter from Ron A. Rhoades, Director, Personal Financial Planning Program and Assistant Professor of Finance, Gordon Ford College of Business, Western Kentucky University (Aug. 6, 2018) ("Rhoades August 2018 Letter"); Former SEC Senior Economists Letter.

[1038] Although the discussion here generally focuses on studies provided by comment letters, at times we have included additional references either to more fully articulate specific arguments or to provide counterarguments to studies provided by comment letters in an effort to present a complete overview of pertinent literature. Because the studies we cite in this section generically discuss investment advice or advice rather than recommendations, and use a variety of terms to describe financial professionals or firms (e.g., brokers, advisers, or financial advisers) and investors (e.g., investors, customers, or clients), in the discussion that follows, we use generic terms of advice or investment advice, financial professional, firm, and retail investor or investor. Although we believe that the studies generally discuss advice as it relates to broker-dealers or investment advisers, because of generic terms used, such as "financial adviser," it is possible that other types of advice providers (e.g., commercial banks, tax consultants, etc.) could be included in some of the studies cited below. However, because not all authors clearly define which financial professionals are included in a given study, we are unable to

investment advice; the benefits attained through investment advice for retail investors; limitations to the value of that advice that stem from agency costs, particularly those related to conflicts of interest arising from financial professional compensation; and evidence of potential investor harm. Where appropriate, we note limitations to the application of various academic studies that form the basis of other economic analyses, which investigate potential investor harm attributed to recommendations received from financial professionals.

a. Who Seeks Investment Advice[1039]

Approximately 37% of U.S. households currently engage with financial professionals according to OIAD/RAND; however, households who hire these professionals are not uniformly distributed among the U.S. population.[1040] In addition to OIAD/RAND, a number of academic

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provide an exhaustive list of all types of financial professionals that make up the market for advice.

1039 One limitation of the majority of the studies examined is that we are unable to distinguish whether the retail investor is seeking and/or receiving investment advice from a broker-dealer or an investment adviser (or some other type of financial professional). The studies generally do not have sufficiently granular data to distinguish broker-dealer customers from investment adviser clients. Further, for studies where retail investors can be distinguished by their investment choices (e.g., purchasing direct-sold versus broker-sold funds), we are unable to determine whether differences exist between broker-sold funds sold by broker-dealers and broker-sold funds sold by investment advisers. As discussed below, some commenters expressed the view that buy-and-hold retail investors were more likely to prefer the services of brokerage accounts over advisory accounts. *See infra* footnote 1055.

1040 According to OIAD/RAND, the use of financial professionals varies by both income and education levels. For example, 38% of retail investors with income greater than $100,000 engage with financial professionals, while only 13.7% of retail investors with

studies, provided with comment letters, examine characteristics of investors and their propensity for seeking (and following) investment advice. Older, wealthier, more educated, and financially more literate retail investors are more likely to seek and act on advice obtained from financial professionals, suggesting that investors who may benefit most from advice (younger, less educated, and less financially sophisticated) are least likely to obtain it.[1041] Several studies examine the choice by retail investors to select into broker-sold or direct-sold mutual funds.

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incomes below $25,000 did so. Another study, the Survey of Consumer Finance, indicates that the use of financial professionals by American households is closer to 60%, but also includes financial planners, accountants, lawyers, and bankers, in addition to broker-dealers and investment advisers. *See* SCF Survey, *supra* footnote 950.

[1041] *See*, *e.g.*, Utpal Bhattacharya et al., *Is Unbiased Financial Advice to Retail Investors Sufficient? Answers from a Large Field Study*, 25 REV. FIN. STUD. 975 (2012); Daniel Hoechle et al., *The Impact of Financial Advice on Trade Performance and Behavioral Biases*, 21 REV. FIN. 871 (2017); Jeremy Burke & Angela A. Hung, *Do Financial Advisors Influence Savings Behavior?*, RAND Labor and Population Report Prepared for the Department of Labor (2015), *available at* https://www.rand.org/content/dam/rand/pubs/research_reports/RR1200/RR1289/RAND_RR1289.pdf; Claude Montmarquette & Nathalie Viennot-Briot, *Econometric Models on the Value of Advice of a Financial Advisor*, CIRANO Project Report No. 2012RP-17 (July 2012), *available at* https://www.cirano.qc.ca/pdf/publication/2012RP-17.pdf; Andreas Hackethal, Michael Haliassos, & Tullio Jappelli, *Financial Advisors: A Case of Babysitters?*, 36 J. BANKING & FIN. 509 (2012). *See also* AARP August 2018 Letter; CFA August 2018 Letter; FPC Letter; Primerica Letter; Wells Fargo Letter (which provided several studies cited here; other studies (e.g., Hoechle et al. (2017)) are included because they capture characteristics of the investors most likely to seek and act on financial advice that are not captured by the studies suggested by the commenters). Studies also note that the characteristics of investors most likely to seek advice are also likely to be those most attractive to financial professionals as they have more assets to manage. *See* Michael S. Finke, *Financial Advice: Does it Make a Difference?* (Working Paper, May 5, 2012) (which describes the relationship between investors and financial professionals).

These studies find less financially sophisticated investors are more likely to purchase "broker-sold" funds and therefore more likely to receive advice from a financial professional.[1042]

As we detail below, retail investors bear costs associated with obtaining advice from financial professionals, which may deter some investors, especially those with limited wealth or income, from seeking investment advice. However, an investor's lack of sophistication may also prevent the investor from obtaining or using investment advice even when advice is provided at no cost. One paper examines the outcomes from a large sample of active retail investors of a large broker-dealer. [1043] These retail investors received unsolicited and unbiased advice from the broker-dealer at no cost. Although the advice was designed to improve the efficiency of the investors' portfolios, only 5% of investors accepted the offer to receive the free advice. Moreover, those that did accept the advice rarely followed the advice. Investors who

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1042 *See*, *e.g.*, Christopher J. Malloy & Ning Zhu, *Mutual Fund Choices and Investor Demographics* (Working Paper, Mar. 14, 2004), *available at* https://pdfs.semanticscholar.org/16a1/8daed89c3c48a765ad3a265018b4d27bd0f4.pdf; John Sabelhaus, Daniel Schrass, & Steven Bass, *Characteristics of Mutual Fund Investors, 2008*, ICI RES. FUNDAMENTALS, Feb. 2009, *available at* https://www.ici.org/pdf/fm-v18n2.pdf; John Chalmers & Jonathan Reuter, *Is Conflicted Advice Better than No Advice?* (Working Paper, Sept. 14, 2015), *available at* https://www.semanticscholar.org/paper/Is-Conflicted-Investment-Advice-Better-than-No-Chalmers-Reuter/3337ce8c3a72bf55dac43f407fd104b93aec863b. *See also* AARP August 2018 Letter; CFA August 2018 Letter; EPI Letter (which provided the Chalmers & Reuter (2015) citation; Malloy & Zhu (2004) and Sabelhaus et al. (2009) are included because they capture aspects of the mutual fund selection decision by retail investors that are not captured by the studies suggested by the commenters). We provide a more detailed discussion of these studies below in Section III.B.3.c.

1043 *See* Bhattacharya et al. (2012), *supra* footnote 1041.

participated in the study had only minimal improvements to their portfolio efficiency. The authors cite lack of financial sophistication and lack of familiarity or trust as reasons why the unsolicited advice was not followed.[1044]

b. Benefits and Limitations of Investment Advice

A number of commenters provided academic studies of benefits that investors may obtain from hiring financial professionals.[1045] One benefit of hiring a firm or financial professional is that professional advice can help the average retail investor overcome common "investment mistakes" that he or she may make when investing.[1046] Common "investment mistakes" made by retail investors include limited allocation of assets to equities, under-diversification, excessive trading, and home bias.[1047] These studies also attempt to identify reasons why retail investors persistently make inefficient investment choices.

1044 *See id*.

1045 *See infra* footnote 1048.

1046 *See* Bhattacharya et al. (2012), *supra* footnote 1041. "Investment mistakes" are investors' actions that would go against what a rational investor would do when undertaking efficient investment decisions (here and below, *infra* footnote 1047, we provide studies that analyze common "investment mistakes" made by retail investors). For example, evidence suggests that retail investors tend to trade too frequently. *See* Brad M. Barber & Terrance Odean, *Trading is Hazardous to Your Wealth: The Common Stock Performance of Individual Investors*, 55 J. FIN. 773 (2000).

1047 As described in Bhattacharya et al. (2012), *supra* footnote 1041, possible explanations for common "investment mistakes" may arise from behavioral biases (e.g., cognitive errors), the cost of information acquisition, or the selection of the financial professional. *See, e.g.*, Luigi Guiso, Paolo Sapienza, & Luigi Zingales, *People's Opium? Religion and Economic Attitudes*, 50 J. MONETARY ECON. 225 (2003); Laurent E. Calvet, John Y. Campbell, &

Beyond correcting potential "investment mistakes," academic studies document a multitude of other benefits that accrue to retail investors as a result of seeking investment advice, including, but not limited to: higher household savings rates, setting long-term goals and calculating retirement needs, more efficient portfolio diversification and asset allocation, increased confidence and peace of mind, improvement in financial situations, and improved tax efficiency.[1048] For example, one study notes that investors who engaged financial professionals

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Paolo Sodini, *Down or Out: Assessing the Welfare Costs of Household Investment Mistakes*, 115 J. POL. ECON. 707 (2007); Barber & Odean (2000), *supra* footnote 1046; Karen K. Lewis, *Trying to Explain Home Bias in Equities and Consumption*, 37 J. ECON. LITERATURE 571 (1999).

[1048] *See*, *e.g.*, Mitchell Marsden, Catherine D. Zick, & Robert N. Mayer, *The Value of Seeking Financial Advice*, 32 J. FAM. & ECON. ISSUES 625 (2011); Jinhee Kim, Jasook Kwon, & Elaine A. Anderson, *Factors Related to Retirement Confidence: Retirement Preparation and Workplace Financial Education*, 16 J. FIN. COUNSELING & PLAN. 77 (2005); Michael S. Finke, Sandra J. Huston, & Danielle D. Winchester, *Financial Advice: Who Pays*, 22 J. FIN. COUNSELING & PLAN. 18 (2011); Daniel Bergstresser, John M.R. Chalmers, & Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, 22 REV. FIN. STUD. 4129 (2009); Ralph Bluethgen, Steffen Meyer, & Andreas Hackethal, *High-Quality Financial Advice Wanted!* (Working Paper, Feb. 2008), *available at* http://citeseerx.ist.psu.edu/viewdoc/summary?doi=10.1.1.596.2310; Neal M. Stoughton, Youchang Wu, & Josef Zechner, *Intermediated Investment Management*, 66 J. FIN. 947 (2011). Marsden et al. (2011) documents benefits attributable to hiring a financial professional, such as better retirement account diversification and savings goals, but does not find that hiring a financial professional measurably increases the amount of overall wealth accumulation for those investors. *See also*, Burke & Hung (2015), *supra* footnote 1041, for additional studies on the causal relation between the use of a financial professional and wealth accumulation. Francis M. Kinniry et al., *Putting a Value on Your Value: Quantifying Vanguard Advisor's Alpha*, Vanguard Research (Sept. 2016), *available at* https://www.vanguard.com/pdf/ISGQVAA.pdf, estimates the value to investors associated with obtaining financial advice of approximately 3% in net returns to

for at least 15 years had approximately 173% more assets on average than investors who did not hire financial professionals, driven by higher household savings rates and increased asset allocation to non-cash instruments.[1049] Further, financial professionals may be able to help retail investors overcome information asymmetries that exist between firms that supply securities and their customers that retail investors would not be able to disentangle on their own.[1050]

Commenters also provided academic studies which discussed the limitations of the advice received from financial professionals, including how both direct and indirect costs of advice can reduce returns earned by investors.[1051] How financial professionals are compensated

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investors, associated with suitable asset allocation, managing expense ratios, behavioral coaching, alleviating home bias, among others. *See also* AARP August 2018 Letter; CCMC Letters; CFA August 2018 Letter; Edward Jones Letter; Letter from Brian M. Nelson (Jul. 10, 2018) ("Nelson Letter") (which provided several of these studies; other studies were included because they capture aspects of the benefits of advice for retail investors that are not captured by the studies suggested by the commenters (e.g., Marsden et al. (2011), Finke et al. (2011)).

1049 *See* Montmarquette & Vionnet-Briot (2012), *supra* footnote 1041. While this study describes the benefits of hiring financial professionals on asset accumulation, it also notes that termination of relationships with financial professionals resulted in a significant loss of overall investment asset value. *See* Primerica Letter; Wells Fargo Letter (which provided references to this academic study).

1050 *See* Roman Inderst & Marco Ottaviani, *Financial Advice*, 50 J. ECON. LITERATURE 494 (2012). *See also* AARP August 2018 Letter.

1051 *See*, *e.g.*, AARP August 2018 Letter; CFA August 2018 Letter; EPI Letter; Letter from Ron A. Rhoades, Director, Personal Financial Planning Program and Assistant Professor of Finance, Gordon Ford College of Business, Western Kentucky University (Dec. 6, 2018) ("Rhoades December 2018 Letter").

can erode the value of advice in two primary ways: (1) the direct costs associated with purchasing advice detract from returns over time[1052]; and (2) the indirect costs to retail investors that arise from conflicts of interest between financial professionals and investors. Financial professionals are generally compensated directly by retail investors in three principal ways: commission-based (e.g., broker-dealers), fee-based on AUM (e.g., investment advisers), and flat or hourly fees (e.g., financial planners), although some financial professionals may receive compensation in multiple ways for providing advice to the same investor.[1053]

[1052] As noted in one study, the direct costs (fees and expenses) may not be transparent to retail investors. Coupled with conflicts of interest that can bias any advice provided, information asymmetry between financial professionals and retail investors may be large. *See* Finke (2012), *supra* footnote 1041.

[1053] For example, investment advisers and supervised persons may receive account-level advisory fees, and may also receive compensation for the sale of securities or other investment products, including asset-based sales charges or service fees for the sale of mutual funds to their advisory clients. *See* Items 5.C, 5.E, and 14.A of Form ADV Part 2A; Items 4.A.2, 4.B, and 5 of Form ADV Part 2B. When we refer to advisers and supervised persons receiving fees for the sale of securities or other investment products, we generally mean advisers that are also registered broker-dealers or advisers whose affiliated broker-dealers receive these fees. Form ADV instructs advisers that if they receive compensation in connection with the purchase or sale of securities, they should carefully consider the applicability of broker-dealer registration requirements of the Exchange Act and any applicable state securities statutes. *See* Form ADV, Part 2A, Note to Item 5.E.

One study estimates that the average annual costs associated with commission-based accounts are approximately 75 bps, while the average fee-based account costs 130 bps.[1054] We acknowledge that in addition to the fees charged for particular types of services, other expenses may be incurred that reduce returns earned by investors, some of which may be earned by the financial professional or the firm and paid by the firm's product or service providers (e.g., fund loads, 12b-1 fees, and shareholder servicing fees).

Some commenters expressed the view that certain investors (e.g., buy-and-hold investors) may prefer to pay a single commission relative to an ongoing fee-based obligation that is tied to AUM in their account.[1055] We note that this choice may be dependent on the investor's holding period and other ongoing expenses that affect an investor's net return over time. For example, a buy-and-hold investor that chooses an account where fees are based on AUM may pay more over time than a similar buy-and-hold investor that pays a single commission. Further, some commission-based securities, such as mutual funds, may have ongoing expenses, including 12b-1

1054 *See* John H. Robinson, *Who's the Fairest of Them All? A Comparative Analysis of Financial Advisor Compensation Models*, 20 J. FIN. PLAN. 56 (2007). *See also* AARP August 2018 Letter. One study, however, argues that when the direct costs associated with commissions are combined with the estimated agency costs, there is little difference in the costs between commission-based and fee-based advice. *See* Quinn Curtis, *The Fiduciary Rule Controversy and the Future of Investment Advice* (Univ. of Va. Sch. of Law, Law & Econ. Research Paper Series No. 2018-04, Mar. 2018). *See also* UVA Letter. We note that services provided may also vary between brokerage and advisory accounts, which could also affect differences in costs paid by retail investors.

1055 *See*, *e.g.*, Cetera August 2018 Letter; AALU Letter; Pacific Life August 2018 Letter; NAIFA Letter; Empower Retirement Letter; CCMR Letter; Primerica Letter.

fees, which could lead to an erosion of net returns over time.[1056] Such ongoing expenses, however, may not be adequately accounted for by investors when making investment decisions about the type of account to open and what type of security to purchase.[1057] Several commenters provided analyses to show the expected effect of one-time costs and ongoing expenses (e.g., operating costs or advisory fees) to investors from both commission-based and fee-based perspectives, conditional on the investor's holding period.[1058]

Separately, investors may face indirect costs that are a result of agency problems that emerge when financial professionals seek to maximize their own compensation and take actions that place their own interests ahead of the investors that they are supposed to serve.[1059] A number of commenters and academic studies have stated that commission-based compensation is

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1056 *See* CFA August 2018 Letter; EPI Letter. *See also* ICI Letter (which described a shift from load to no load funds, decreasing expense ratios, and a decline in the percentage of funds that charge 12b-1 fees).

1057 *See infra* footnote 1084 and corresponding discussion.

1058 *See*, *e.g.*, Cetera August 2018 Letter and November 2018 Letter; Pacific Life August 2018 Letter.

1059 *See* Jeremy Burke et al., *Impacts of Conflicts of Interest in the Financial Services Industry* (RAND Labor & Population, Working Paper No. WR-1076, Feb. 2015), *available at* https://www.rand.org/pubs/working_papers/WR1076.html; Hamid Mehran & Rene M. Stulz, *The Economics of Conflicts of Interest in Financial Institutions*, 85 J. FIN. ECON. 267 (2007). *See also* Letter from D. Bruce Johnsen, Professor of Law, Scalia Law School, George Mason University (Aug. 7, 2018) ("Johnsen Letter"); Robinson (2007), *supra* footnote 1054. Broker-dealers may act in a brokerage (i.e., agency) capacity or a dealer (i.e., principal) capacity. *See* Proposing Release at Section I. While the discussion is framed in terms of agency problems, it is applicable to both capacities.

more likely to contribute to conflicts of interest between financial professionals and retail investors than fee-based compensation.[1060] Other commenters, however, indicated that commission-based compensation provides benefits to investors.[1061] One study finds that conflicts of interest are likely to be present in *all* forms of compensation earned by financial professionals. For example, fee-based compensation could result in so-called "reverse churning" and a disincentive to reduce AUM, even if that would be in the investor's best interest, while flat-fee models can lead to shirking and overbilling.[1062] However, due to limitations on the data available regarding fee-based advice, most of the academic studies to date regarding conflicts of interest focus on commission-based compensation models. As such, the potential conflicts associated with the fee-based compensation models, including fee-based compensation earned by broker-dealers, have not been subject to as much analysis. Studies show that commission-based compensation potentially leads to biased advice, including excessive trading in accounts and recommendations to purchase high-commission securities, both of which benefit the financial professional and may lead to lower net returns.[1063]

1060 *See* IPA Letter; CFA August 2018 Letter.

1061 *See* AALU Letter; Invesco Letter; ACLI Letter; NAIFA Letter. *See* Burke et al. (2015), *supra* footnote 1059 for a survey on the academic literature on conflicts of interest.

1062 *See* Robinson (2007), *supra* footnote 1054.

1063 *See, e.g.*, Stoughton et al. (2011), *supra* footnote 1048; Roman Inderst & Marco Ottaviani, *Misselling Through Agents*, 99 AM. ECON. REV. 883 (2009); Max Beyer, David de Meza, & Diane Reyniers, *Do Financial Advisor Commissions Distort Client*

Financial professionals also may benefit from other forms of transaction-based payment from customers, such as mark-ups and mark-downs; for instance, one study documents that the size of the mark-up or mark-down is significantly positively related to whether the broker-dealer solicits the transaction and whether the broker-dealer acts in a principal capacity.[1064] Because mark-ups and mark-downs are payments from the customer to the broker-dealer, they give rise to conflicts of interest between a broker-dealer and his or her customer at the time of a recommendation, particularly if they are opaque to the customer, at the time of the recommendation. Mechanisms, including regulation,[1065] disclosure, and reputation,[1066] may be

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Choice?, 119 ECON. LETTERS 117 (2013). *See also* AARP August 2018 Letter. Financially unsophisticated investors, as discussed by Stoughton et al. (2011), are those most likely to purchase inefficient assets.

1064 *See* Allen Ferrell, *The Law and Finance of Broker-Dealer Mark-Ups* (Harvard John M. Olin Ctr. for Law, Econ., and Bus., Discussion Paper, Apr. 6, 2011), *available at* https://www.finra.org/sites/default/files/NoticeAttachment/p123492.pdf. *See* AARP August 2018 Letter.

1065 *See, e.g.*, antifraud provisions of the federal securities laws, FINRA Rule 2121 (Fair Prices and Commissions); MSRB Rules G-15 and G-30, amended pursuant to Exchange Act Release No. 79347 (Nov. 17, 2016) [81 FR 84637] (Nov. 23, 2016); and FINRA Rules 2121 and 2232, amended pursuant to Exchange Act Release No. 79346 (Nov. 17, 2016) [81 FR 84659] (Nov. 23, 2016).

1066 *See* William P. Rogerson, *Reputation and Product Quality*, 14 BELL J. ECON. 508 (1983); Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981); W. Bentley MacLeod, *Reputations, Relationships, and Contract Enforcement*, 45 J. ECON. LITERATURE 595 (2007) for theoretical models of the effect of reputation on investment quality. *See* AARP August 2018 Letter. For example, FINRA and MSRB introduced rules in May 2018 regarding mark-up disclosure rules for same-day trades, allowing investors to be able to see what

able to mitigate the risk of financial professionals acting on conflicts of interest to the detriment of their customers.[1067] In addition to direct payments of commissions from retail investors, financial professionals may receive payments from third parties, such as securities issuers, which can increase costs to investors through higher management fees and reduced net returns, and provide incentives to recommend these securities over those that do not provide such incentives.[1068]

While a number of studies suggest that conflicts of interest may lead to investor harm, one study, which provides a survey of the literature on conflicts of interest, states that "although conflicts of interest are omnipresent when contracting is costly and parties are imperfectly

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they have paid for riskless principal transactions (FINRA Rule 2232 and MSRB Rule G-15). The Commission has also brought enforcement cases for undisclosed excessive markups under Exchange Act Rule 10b-5.

1067 *See, e.g.*, Inderst & Ottaviani (2012), *supra* footnote 1050. *See also* Bolton et al. (2007), *infra* footnote 1073, which posits that competition or consolidation affect reputation costs and provide a disciplining mechanism for providers of financial advice. Although various mechanisms exist to address agency problems in general, such as monitoring, bonding, and contracting (*see, e.g.*, Finke (2012), *supra* footnote 1041), the agency problem between financial professionals and retail investors is not necessarily one that can be solved cost-effectively through these approaches. *See infra* Section III.A.2 for a discussion of limitations to these approaches. See *also* Curtis (2018), *supra* footnote 1054. *See also* AARP August 2018 Letter; CFA August 2018 Letter; UVA Letter.

1068 *See* Stoughton et al. (2011), *supra* footnote 1048. The authors also state that "[i]n addition to the advisory fees charged to the clients, wrap account managers may receive rebates from fund management companies as well," and that wrap accounts have increased in popularity. *See also* Mark Egan, *Brokers vs. Retail Investors: Conflicting Interests and Dominated Products*, J. FIN. (forthcoming 2019). *See also* AARP August 2018 Letter; CFA August 2018 Letter.

informed, there are important factors that mitigate their impact and, strikingly, it is possible for customers of financial institutions to benefit from the existence of such conflicts… The existence of a conflict of interest… does not mean that… the customers of that institution will be harmed… [A] variety of mechanisms help control conflicts of interest and their impact [e.g., a financial institution's reputation]."[1069] Another study of commission-based compensation in the United Kingdom indicates that commission-based compensation leads to significant bias in certain types of securities (e.g., with profit bonds or distribution bonds) and financial professionals and when bias exists, retail investors are harmed and the costs associated with such harm are significant; however, the study also states that the advice market in the United Kingdom is not overrun with bias ("adviser recommendations are not dominated by self-interest") and the market for advice generally works well.[1070]

[1069] *See* Mehran & Stulz (2007), *supra* footnote 1059. *See also* Johnsen August 2018 Letter.

[1070] *See* Robert Laslett, Tim Wilsdon, & Kyla Malcolm, *Polarisation: Research into the Effect of Commission Based Remuneration on Advice*, Charles River Associates Report Submitted to the U.K. Financial Services Authority (Jan. 2002), *available at* http://www.crai.com/sites/default/files/publications/polarisation-research-into-the-effect-of-commission-based-remuneration-on-advice.pdf. Laslett et al. (2002) estimate harm resulting from biased advice of approximately £140 million per year. Following the ban on commission-based compensation in the U.K. in 2013, another study finds that while the quality of financial advice increases, increased costs of providing advice lead some financial professionals to turn away small retail investors. *See* Tracey McDermott & Charles Roxbury, *Financial Advice Market Review*, Financial Conduct Authority and HM Treasury Final Report (Mar. 2016) , *available at* https://www.fca.org.uk/publication/corporate/famr-final-report.pdf (which provides an overview of the effects of the Retail Distribution Review by the Financial Conduct Authority in the United Kingdom). Further, McDermott & Roxbury (2016) report that

Although financial professionals may aid retail investors in correcting common investing mistakes and overcoming informational hurdles associated with securities transactions or investment strategies, the average retail investor may not be able to assess the quality of advice received from financial professionals.[1071] The difficulty in assessment can arise from several sources, including a large degree of heterogeneity in the quality of advice, insufficient financial literacy on the part of investors, and information asymmetry between the financial professional and investors.[1072] Information asymmetry arises when information necessary to assess the quality of the advice received may not be available to the retail investor, even when it is available to the financial professional. For example, a financial professional may disclose

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financial advice costs approximately £150 per hour and that giving retirement advice requires an average of nine hours on the part of the financial professional.

1071 A number of studies consider advice to be a credence good, which is a type of good with qualities that cannot be observed by the consumer after purchase, making it difficult to assess its utility. *See*, *e.g.*, Roman Inderst, *Consumer Protection and the Role of Advice in the Market for Retail Financial Services*, 167 J. INSTITUTIONAL & THEORETICAL ECON. 4 (2011) (which provides a review of investors' ability to assess the quality of investment advice).

1072 *See, e.g.*, Bluethgen et al. (2008), *supra* footnote 1048. Although this study documents reasons why investors may be unable to assess the quality of advice, the focus is on using adviser characteristics as screening mechanisms to alleviate the first complication noted, the high degree of heterogeneity in the quality of advice. The paper finds that good predictors of high quality advice include the financial professional's cognitive ability (e.g., analytical skills, rationality, and financial knowledge), how financial professionals are compensated (financial professionals that have a high fraction of commission-based revenue are less likely to recommend high quality investments, e.g., index funds), and the firm's business model. *See also* Finke (2012), *supra* footnote 1041; AARP August 2018 Letter. *See also* Relationship Summary Adopting Release.

conflicts of interest that could affect the advice provided, but the information may not be sufficiently precise to help a retail investor gauge how those conflicts affect the advice provided.

Conflicts of interest, therefore, can erode the benefits of advice provided to retail investors, particularly if investors are unaware that the conflicts exist or if they do not understand the implications of conflicts.[1073] Financial professionals may use this information asymmetry, particularly with unsophisticated investors, to capture economic rents for themselves, and this could exacerbate biases that investors sometimes exhibit, such as return chasing or under-diversification.[1074] One experimental study sent "mystery shoppers" to broker-dealers and investment advisers in several large cities in the United States and found that financial professionals provided recommendations that benefited themselves and exacerbated behavioral

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1073 *See, e.g.*, Inderst & Ottaviani (2012), *supra* footnote 1050; Patrick Bolton, Xavier Freixas, & Joel Shapiro, *Conflicts of Interest, Information Provision, and Competition in the Financial Services Industry*, 85 J. FIN. ECON. 297 (2007). *See also* AARP August 2018 Letter.

1074 *See, e.g.*, Marco Ottaviani, *The Economics of Advice* (Working Paper, May 2000), *available at* http://faculty.london.edu/mottaviani/EOA.pdf (included because they capture aspects of the information asymmetries between retail investors and financial professionals that are not captured by the studies suggested by the commenters); Miriam Krausz & Jacob Paroush, *Financial Advising in the Presence of Conflict of Interests*, 54 J. ECON. & BUS. 55 (2002); Inderst & Ottaviani (2012), *supra* footnote 1050; Stoughton et al. (2011), *supra* footnote 1048. *See also* AARP August 2018 Letter.

biases on the part of investors, including return chasing or recommendations of high-cost actively managed funds.[1075]

Although financial professionals may be hired to help overcome "investment mistakes" made by investors,[1076] a number of studies show that financial professionals themselves may be subject to the same behavioral biases as unadvised retail investors, such as return chasing and overconfidence.[1077] One study, using data on Canadian investors and their financial

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1075 *See* Sendhil Mullainathan, Markus Noeth, & Antoinette Schoar, *The Market for Financial Advice: An Audit Study* (Nat'l Bureau of Econ. Research, Working Paper No. 17929, Mar. 2012), *available at* https://www.nber.org/papers/w17929.pdf. *See also* AARP August 2018 Letter; CFA August 2018 Letter; EPI Letter. Although the Mullainathan et al. (2012) study included both broker-dealers and investment advisers, the study notes that most professionals in their sample focused on the lower end of the retail spectrum and tended to be compensated through commissions rather than fees based on AUM. *See also* Santosh Anagol, Shawn Cole, & Shayak Sarkar, *Understanding the Advice of Commissions Motivated Agents: Evidence from the Indian Life Insurance Market* (Harvard Bus. Sch., Working Paper No. 12-055, Oct. 2015), *available at* https://www.hbs.edu/faculty/Publication%20Files/12-055_13c23c02-e57f-4aea-9630-316aa4b772ce.pdf, which used a similar audit approach to evaluate the quality of advice provided by life insurance agents in India, and found that agents recommended unsuitable products and strategies that paid high commissions.

1076 *See supra* footnote 1046.

1077 *See, e.g.*, Mullinathan et al. (2012), *supra* footnote 1075; Terrance Odean, *Are Investors Reluctant to Realize Their Losses?*, 53 J. FIN. 1775 (1998); Zur Shapira & Itzhak Venezia, *Patterns of Behavior of Professionally Managed and Independent Investors*, 25 J. BANKING & FIN. 1573 (2001). *See also* AARP August 2018 Letter. *See also* Anagol et al. (2015), *supra* footnote 1075, which documents that life insurance agents in India purchase the same inefficient products that they recommend to their clients. One study of Canadian financial professionals and their clients observed a commonality among portfolios of a given financial professional, and that the financial professional's own portfolio allocations strongly predicted the asset allocations of his or her customers,

professionals, observes that financial professionals appear to have the same "misguided beliefs" as their investors, and therefore do not correct, and may even exacerbate common investment mistakes.[1078] In that study, financial professionals invested in the same manner that they recommended to their clients; they traded excessively, chased returns, bought expensive actively managed funds, under-diversified their portfolios, and earned similar net returns. Further, these financial professionals continued to follow similar investment strategies as those they recommended to their clients, even after they had left the industry, suggesting that they believed their own investment advice.[1079]

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indicating limited customization, regardless of the customer's risk tolerance, age, or financial sophistication. Although the results of this paper indicate that conflicts of interest are unlikely to motivate advice because financial professionals and their investors hold similar portfolios, it does raise questions of the high cost of financial advice when customization is limited. *See* Stephen Foerster et al., *Retail Financial Advice: Does One Size Fit All?*, 72 J. FIN. 1441 (2017) (included because they capture insights into how financial professionals may be subject to similar biases as retail investors that are not captured by the studies suggested by the commenters). *See* Robinson (2007), *supra* footnote 1054.

1078 *See* Juhani T. Linnainmaa, Brian T. Melzer, & Alessandro Previtero, *The Misguided Beliefs of Financial Advisors* (Kelley Sch. of Bus., Research Paper No. 18-9, May 2018), *available at* http://www.aleprevitero.com/wp-content/uploads/2018/06/SSRN-id3101426.pdf. *See also* CFA August 2018 Letter.

1079 Linnainmaa et al. (2018), *supra* footnote 1078, also suggest that conflicts of interest may not be driven by financial professionals, but instead are between the firm and its clients, and that firms deliberately hire financial professionals who believe their misguided (and ultimately expensive) advice. In light of their findings, the authors suggest that regulation designed to stem conflicts of interest could be ineffective if aligning investors and financial professionals does not alter the advice that they provide, could raise barriers to entry that could reduce the amount of advice available, and may limit investor choice.

c. Evidence of Potential Investor Harm

A number of commenters provided citations to academic studies that analyze the evidence of potential investor harm driven by conflicts of interest of financial professionals.[1080] A number of these studies, including Bergstresser et al. (2009), Del Guercio and Reuter (2014), and Christoffersen, Evans, and Musto (2013), underpinned the economic analyses of the Council of Economic Advisors 2015 Study ("CEA Study") and the DOL RIA assessment of the aggregate harm borne by retail investors in retirement plans due to conflicts of interest.[1081]

[1080] *See, e.g.*, AARP August 2018 Letter; Better Markets August 2018 Letter; CFA August 2018 Letter; EPI Letter; State Attorneys General Letter.

[1081] *See* Letter from Linda Agerbak (Jun. 21, 2018) ("Agerbak Letter"); Better Markets August 2018 Letter; CFA August 2018 Letter; EPI Letter; Letter from Public Citizen (Aug. 7, 2018) ("Public Citizen Letter"); State Attorneys General Letter; Former SEC Senior Economists Letter. *See also* Bergstresser et al. (2009), *supra* footnote 1048; Diane Del Guercio & Jonathan Reuter, *Mutual Fund Performance and the Incentive to Generate Alpha*, 69 J. FIN. 1673 (2014); Susan E.K. Christoffersen, Richard Evans, & David K. Musto, *What Do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives*, 68 J. FIN. 201 (2013). *See* Office of the President of the United States, Council of Economic Advisers, *The Effects of Conflicted Investment Advice on Retirement Savings* (Feb. 2015), *available at* https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf. *See also* DOL RIA, *supra* footnote 1002. Both the CEA Study and the DOL RIA assumed that the DOL Fiduciary Rule would eliminate all conflicts of interest and, therefore, all of the harms to retirement investors resulting from conflicts. *See also* Curtis (2018) and *infra* footnote 1103. By contrast, Regulation Best Interest would not require elimination or mitigation of firm-level conflicts, and will require written policies and procedures reasonably designed to eliminate or mitigate of some representative-level conflicts, which means that some conflicts and their attendant harms may remain, especially at the firm level. The disclosure requirements of Regulation Best Interest,

Below we discuss evidence of potential investor harm attributable to recommendations of certain investments by financial professionals, including mutual funds, 401(k) plans, corporate bonds, and non-traded REITs. We then discuss the aggregate measures of investor harm estimated by the CEA Study and the DOL RIA and the limitations of those estimates.

Directly addressing the question of whether and how brokerage customers or advisory clients are affected by conflicts of interest (e.g., through quantification) requires measurement of the effect of advice, subject to different levels of conflict, received from broker-dealers or investment advisers. Most data currently available to researchers does not make distinctions between types of firms or financial professionals, and generally aggregates all firms or financial professionals into a single category of financial professionals (e.g., "adviser" or "financial adviser"). Further, an investor's propensity to choose a particular type of relationship may be correlated with the investor's skill or choice of investment and, therefore, may introduce bias into studies that are able to differentiate between types of advice relationships. Despite these limitations, by examining the existing academic literature, discussed below, we are able to gain qualitative insight into, and address commenter concerns, about conflicts of interest in the market for financial advice and the potential harm to investors.

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however, may empower some customers to push back on broker-dealer conflicts of interest and more generally may have a deterrent effect.

The majority of studies to date that investigate the potential harm to investors arising from potential conflicts of interest have generally centered on findings based on analysis of investments in mutual funds. Due to the readily available data for mutual funds, the literature is rich with studies exploring various aspects of those securities, including the performance of funds, relationships between flows and performance or expenses, and differences in performance of funds depending on the distribution channel. These studies have further been used by commenters and other providers of economic analyses to estimate the magnitude of investor harm potentially stemming from conflicts of interest as it relates to mutual fund investments.[1082]

Evidence suggests that there is a strong relationship between past performance and subsequent fund flows, even when funds do not persistently outperform, suggesting that investors and/or their financial professionals may engage in return-chasing behavior.[1083] Several

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1082 *See* CEA Study, *supra* footnote 1081, and DOL RIA, *supra* footnote 1002. *See also* EPI Letter; Better Markets August 2018 Letter; St. John's U. Letter; Letter from Royce A. Charney, President, Trust Administrators (Aug. 7, 2018) ("Charney Letter"); Agerbak Letter; CFA August 2018 Letter.

1083 *See* Judith Chevalier & Glenn Ellison, *Risk Taking by Mutual Funds as a Response to Incentives*, 105 J. POL. ECON. 1167 (1997); Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. POL. ECON. 1269 (2004); Brad M. Barber, Terrance Odean, & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flow*, 78 J. BUS. 2095 (2005); Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589 (1998). In the theoretical model provided by Berk and Green (2004), active funds do not outperform passive funds because investors compete to invest in strong past performers (i.e., they chase returns), driving these funds' returns to the competitive level. *See also* AARP August 2018 Letter; CFA August 2018 Letter.

studies also examine the effect of mutual fund costs, and find that (1) fund flows are negatively related to front-end loads, but are relatively insensitive to fund-level operating expenses (e.g., 12b-1 fees), indicating that investors may be aware of upfront costs when selecting funds, but may be less attuned to the effect on net returns of ongoing operating expenses;[1084] and (2) unsophisticated investors are more likely to pay higher fees than sophisticated investors and are less likely to expend search costs to look for lower-fee funds.[1085] Retail investors, however, can benefit when funds commence operation of an institutional "twin" fund as overall expenses decrease and managerial effort increases, suggesting that retail investors may not be able to monitor fund managers as effectively as institutional investors.[1086]

Analyses in the CEA Study and the DOL RIA focus on the underperformance of certain broker-sold funds, potentially driven by conflicts of interest and a misalignment of incentives between financial professionals and investors.[1087] A number of studies document that actively managed load mutual funds purchased by investors through a financial professional

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1084 *See* Barber et al. (2005), *supra* footnote 1083.

1085 *See* Todd Houge & Jay Wellman, *The Use and Abuse of Mutual Fund Expenses*, 70 J. BUS. ETHICS 23 (2007). *See* AARP August 2018 Letter.

1086 *See* Richard B. Evans & Rudiger Fahlenbrach, *Institutional Investors and Mutual Fund Governance: Evidence from Retail-Institutional Fund Twins*, 25 REV. FIN. STUD. 3530 (2012). *See* AARP August 2018 Letter. The authors identify funds as "twins" if they share the same manager, investment objectives, fund families, and have a gross return correlation of 0.95 or greater.

1087 *See* CEA Study, *supra* footnote 1081, and DOL RIA, *supra* footnote 1002.

underperform other types of mutual funds.[1088] For example, several studies find that actively managed load funds underperform a buy-and-hold strategy by between 1.56% and 2.28% annually, while other studies show that actively managed load funds underperform no-load funds by between 1% and 1.5% per year.[1089] This underperformance could be driven by poor market timing of investors (e.g., return chasing),[1090] or because increased expenditures by the funds on marketing and advertising successfully attract retail flows, and such expenses decrease net returns to investors over time.[1091] Fees and expenses, as documented by several studies, are two

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[1088] *See* Bergstresser et al. (2009), *supra* footnote 1048; Del Guercio & Reuter (2014), *supra* footnote 1081.

[1089] *See, e.g.*, Mercer Bullard, Geoffrey Friesen, & Travis Sapp, *Investor Timing and Fund Distribution Channels* (Working Paper, 2008); Geoffrey C. Friesen & Travis R.A. Sapp, *Mutual Fund Flows and Investor Returns: An Empirical Examination of Fund Investor Timing Ability*, 31 J. BANKING & FIN. 2796 (2007); Matthew R. Morey, *Should You Carry the Load? A Comprehensive Analysis of Load and No-Load Mutual Fund Out-of-Sample Performance*, 27 J. BANKING & FIN. 1245 (2003). *See also* Eugene F. Fama & Kenneth R. French, *Luck Versus Skill in the Cross-Section of Mutual Fund Returns*, 65 J. FIN. 1915 (2010), which notes that although some active managers may outperform passive benchmarks while others underperform, on average, the alpha attributable to active management will net to zero; therefore, net of fees, on average, and the alpha earned by actively managed funds will be reduced by the aggregate amount of fees and expenses of active management. *See also* William F. Sharpe, *The Arithmetic of Active Management*, 47 FIN. ANALYSTS J. 7 (1991). *See* AARP August 2018 Letter; CFA August 2018 Letter.

[1090] *See, e.g.*, Bullard et al. (2008), *supra* footnote 1089; Friesen & Sapp (2007), *supra* footnote 1089.

[1091] One study documents that heavily advertised funds outperform their benchmarks prior to the marketing efforts, but do not outperform their benchmarks in the post-advertising period. These funds, however, attract significantly more inflows, relative to a control

of the most reliable predictors of future returns, and fees should reflect performance (e.g., funds with high fees hypothetically should have better ex post performance in order to justify the fees), as at least some portion of the fees are dedicated to portfolio management; however, these studies consistently find a negative relationship between fees and performance—lower cost funds on average are more likely to generate higher performance net of fees than high cost funds.[1092]

A number of studies, also cited by the DOL RIA and the CEA Study, explore the distinction between broker-sold funds and direct-sold funds, and the effect of the distribution channel on fund flows and performance. When examining a sample of only broker-sold funds, one study shows that funds that pay higher fees to financial professionals or charge higher excess

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group. *See* Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937 (2000). *See also* Nikolai Roussanov, Hongxun Ruan, & Yanhao Wei, *Marketing Mutual Funds* (Nat'l Bureau of Econ. Research, Working Paper No. 25056, Sept. 2018), *available at* https://www.nber.org/papers/w25056.pdf. *See* AARP August 2018 Letter; CFA August 2018 Letter; EPI Letter.

1092 *See* Javier Gil-Bazo & Pablo Ruiz-Verdu, *The Relation Between Price and Performance in the Mutual Fund Industry*, 64 J. FIN. 2153 (2009); Russel Kinnel, *Predictive Power of Fees: Why Mutual Fund Fees Are So Important*, Morningstar Manager Research (May 2016); William F. Sharpe, *The Arithmetic of Investment Expenses*, 69 FIN. ANALYSTS J. 34 (2013). Gil-Bazo & Ruiz-Verdu (2009) find that actively managed funds with the worst performance charge, on average, the highest fees. *See* AARP August 2018 Letter; CFA August 2018 Letter.

loads generate greater fund inflows.[1093] Moreover, broker-sold funds, on average, underperform direct-sold funds by between 23 bps and 255 bps per annum, with most studies observing average underperformance of approximately 100 bps (1%) per year.[1094]

Further, conflicts of interest appear to depend upon the choice of investment (e.g., broker-sold versus direct-sold funds) as well as the magnitude of the costs (e.g., mutual fund loads). One study suggests that the market for funds is segmented: more financially sophisticated investors select direct-sold funds, which unbundle portfolio management from advice of financial professionals, while less financially sophisticated investors purchase broker-sold funds, which combine portfolio management and advice.[1095] Another study focuses

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[1093] *See* Christoffersen et al. (2013), *supra* footnote 1081; Chalmers & Reuter (2015), *supra* footnote 1042; Jasmin Sethi, Jake Spiegel, & Aron Szapiro, *Conflicts of Interest in Mutual Fund Sales: What Do the Data Tell Us?*, 6 J. RETIREMENT 46 (2019). Christoffersen et al. (2013) and Sethi et al. (2019) measure excess loads by first estimating the baseline (average) load paid with regressions of loads on a number of explanatory variables, then using the residuals from these regressions (excess loads) to explain fund flows and performance. *See also* Morningstar Letter; Letter from Aron Szapiro, Director of Policy Research, Morningstar, Inc., et al. (Aug. 24, 2018) ("Morningstar Letter Supplement"). Sethi et al. (2019) find, however, that the relation between excess loads and fund flows tapered off after the DOL Fiduciary Rule was adopted, suggesting that the DOL Fiduciary Rule may have discouraged financial professionals from directing flows to funds with high excess loads.

[1094] *See, e.g.*, Bergstresser et al. (2009), *supra* footnote 1048; Chalmers & Reuter (2015), *supra* footnote 1042; Xuanjuan Chen, Tong Yao, & Tong Yu, *Prudent Man or Agency Problem? On the Performance of Insurance Mutual Funds*, 16 J. FIN. INTERMEDIATION 175 (2007). *See* AARP August 2018 Letter.

[1095] *See* Del Guercio & Reuter (2014), *supra* footnote 1081. Moreover, this study finds that broker-sold actively managed funds underperform broker-sold index funds by between

exclusively on broker-sold funds, but segments those funds into groups that depend on the size of excess loads and whether the funds are sold by affiliated or unaffiliated brokers.[1096] That study observes that funds with a one-standard deviation increase in excess loads are related to a reduction in future performance of between 34 bps and 49 bps in the following year. As detailed in Bergstresser et al. (2009), the broker-sold channel is likely to include funds sold through both broker-dealers and investment advisers; however, the data provided to the authors is not granular enough to be able to distinguish the performance characteristics of the two distinct channels.[1097]

A number of commenters stated that the Proposing Release did not appropriately account for existing economic analyses produced by the CEA Study and the DOL RIA to measure the

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1.1% and 1.3% per year, which the authors suggest may reflect an agency conflict. *See also* Diane Del Guercio, Jonathan Reuter, & Paula A. Tkac, *Broker Incentives and Mutual Fund Market Segmentation* (Nat'l Bureau of Econ. Research, Working Paper No. 16312, Aug. 2010), *available at* https://www.nber.org/papers/w16312.pdf. *See* AARP August 2018 Letter; CFA August 2018 Letter. Although some of the growth in direct-sold funds comes from passive investing (e.g., index funds), greater than 75% of the number of direct-sold funds are actively managed (as of 2012). *See* Jonathan Reuter, *Revisiting the Performance of Broker-Sold Mutual Funds* (Working Paper, Nov. 2, 2015), *available at* https://www2.bc.edu/jonathan-reuter/research/brokers_revisited_201511.pdf.

1096 *See* Christoffersen et al. (2013), *supra* footnote 1081.

1097 *See* Bergstresser et al. (2009), *supra* footnote 1048. The Bergstresser et al. study also notes that many funds in the direct-sold channel may be recommended by fee-based advisers, whose services "are typically paid for with an advisory fee that is outside of the fund expenses or distribution costs. As a practical matter, the 'direct' channel may not be as direct as one might imagine."

potential harm to investors from conflicts of interest.[1098] The CEA Study and the DOL RIA use the literature on underperformance of broker-sold mutual funds as the foundation for their analyses on the potential harm of retail investors, focusing on harm specifically directed at retirement savings. Applying an estimate of approximately 1% underperformance to broker-sold funds, which is consistent with estimates of underperformance provided by several studies,[1099] the CEA Study and the DOL RIA apply different methods and approaches to calculate the aggregate dollar harm for retail investors in their retirement accounts.[1100] Based on $1.7 trillion invested in potentially conflicted funds, the CEA Study estimates annual harm to retirement investors of approximately $17 billion.[1101] Similarly, the DOL RIA, which estimates potential

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1098 *See also* ARA August 2018 Letter; EPI Letter; Better Markets August 2018 Letter; St. John's U. Letter; Charney Letter; Agerbak Letter; CFA August 2018 Letter.

1099 *See* Bergstresser et al. (2009), *supra* footnote 1048; Del Guercio & Reuter (2014), *supra* footnote 1081; Christoffersen et al. (2013), *supra* footnote 1081. A number of commenters, regarding the DOL RIA, indicated that both the CEA Study, *supra* footnote 1081, and the DOL RIA, *supra* footnote 1002, misinterpreted estimated effects described in the Christoffersen et al. (2013) paper, and overstated the potential harm associated with funds with high excess loads by more than double the actual estimate had the interpretation been correct. *See* Craig M. Lewis, *The Flawed Cost-Benefit Analysis Underlying the Department of Labor's Fiduciary Rule* (White Paper, Aug. 2017), *available at* https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2268185-160965.pdf; Public Interest Comment from Mark Warshawsky & Hester Peirce, George Mason University Mercatus Center (Apr. 17, 2017), *available at* https://www.mercatus.org/system/files/warshawsky-dol-fiduciary-rule-pic-v1.pdf. *See also* Curtis (2018), *supra* footnote 1054.

1100 *See* CEA Study, *supra* footnote 1081, and DOL RIA, *supra* footnote 1002.

1101 *See* CEA Study, *supra* footnote 1081.

loss due to conflicts of interest of between 50 bps and 100 bps per year, produces ten-year aggregate estimates of investor harm of between $95 billion and $189 billion stemming from the underperformance of broker-sold mutual funds.

The level of underperformance due to fund selection is highly sensitive to the data sample, including the sample period, as well as the methodology employed to calculate performance. Many of the studies used to support the analyses underlying the CEA Study and the DOL RIA rely on data obtained prior to 2011. However, since 2011 there have been a number of advances in the market for mutual funds (e.g., shifts from load to no-load funds and increase in no-load funds without 12b-1 fees), likely leading some of the inferences drawn from those studies to be dated and not reflective of the current market environment.[1102] A number of commenters indicated potential flaws associated with the approach and interpretation of the analyses used by the CEA Study and the DOL RIA.[1103] One study updates the Del Guercio and Reuter (2014)

[1102] *See* ICI Letter and Section III.B.2.e.ii, *supra*.

[1103] *See* Lewis (2017), *supra* footnote 1099; Warshawsky & Peirce (2017), *supra* footnote 1099. *See also* Curtis (2018), *supra* footnote 1054. To date, only one academic study of which we are aware (Curtis (2018)) has analyzed the DOL Fiduciary Rule and the DOL RIA, and discusses issues with the approach taken by the DOL RIA in estimating the benefits and costs of the DOL Fiduciary Rule, noting that the DOL RIA likely underestimates the potential costs of the rule. This study also indicates that the net benefits of the DOL Fiduciary Rule are expected to be close to zero because the DOL Fiduciary Rule may not completely eliminate conflicts of interest and the actual cost of investment advice at the intermediary-level was excluded from the DOL RIA computation of benefit. Once the calculation accounted for costs of advice, Curtis (2018) estimates that the total costs attributed to conflicts of interest, including

sample using data from between 2003 and 2012 and tests the robustness of the methodology by examining the underperformance of broker-sold funds relative to direct-sold funds.[1104] While underperformance of broker-sold funds still existed, depending on the methodology and empirical approach used, the underperformance of these funds was reduced to between 20 bps and 70 bps, with the majority of the estimation approaches falling to between 20 bps and 50 bps, indicating a reduction in the underperformance of broker-sold funds relative to earlier studies.[1105] Another study replicates the Christoffersen et al. (2013) analysis of excess loads on underperformance using data from between 2010 and 2017, and finds that after 2010, funds with high excess loads did not underperform funds with low excess loads, which the authors interpret as evidence that financial professionals have improved their recommendations over time.[1106]

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underperformance of some securities, is only slightly higher than the costs associated with advice that is free of conflicts.

1104 *See* Reuter (2015), *supra* footnote 1095.

1105 Reuter (2015), *supra* footnote 1095, states that "[t]hese changes suggest that the average broker-sold fund has become more competitive with the average direct-sold fund"; however additional research would be required to determine if these changes are driven by existing fund families, new fund families, or some combination of factors. When performance is value-weighted, Reuter (2015) discusses that brokers appear to direct clients toward funds that pay "higher-than-average distribution costs."

1106 *See* Sethi et al. (2019), *supra* footnote 1093. The authors note that the underperformance of high excess load funds becomes statistically insignificant in the analysis only with the inclusion of prior-year performance of the fund (which Christoffersen et al. (2013), *supra* footnote 1081, include in one of their models). The authors suggest that the reduction in flows to funds with excess loads could be due in part to the DOL Fiduciary Rule; however, they also note that their analysis does not reveal a clear association between the

Taken together, these recent studies on fund selection suggest that the magnitude of potential investor harm likely is not as large as that estimated by the CEA Study and the DOL RIA when more recent data is used to compute the underperformance of broker-sold mutual funds.

Another recent study replicates and extends the Friesen and Sapp (2007) and Bullard et al. (2008) analyses of market timing ability by investors in mutual fund sales and purchases to newer data (2007 through 2016).[1107] The study shows that the difference between dollar returns and buy-and-hold returns ("performance gap") declined from 1.56% between 1991 and 2004 to 1.01% between 2007 and 2016 for a combined sample of load and no-load funds, suggesting a moderation in market timing errors in the most recent period. However, the excess performance gap (the difference between the performance gap on load funds and no load funds) has slightly increased between 2007 and 2016, from approximately 1% to 1.12%, indicating that, to the extent that load funds are sold by financial professionals and that all inflows and outflows are due solely to market timing motivations, investors who hold load funds are more prone to market timing errors than investors in no-load funds, and these errors are not being corrected by financial professionals. The studies discussed above acknowledge that interpretation of the

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DOL Fiduciary Rule and returns. The authors further cite to Holden et al. (2018), *supra* footnote 955, which discusses the shift away from load mutual funds to no-load funds over time. *See also* ICI Letter; Morningstar Letter; Morningstar Letter Supplement.

1107 *See* Karthik Padmanabhan, Constantijn Panis, & Timothy Tardiff, *The Ability of Investors to Time Purchases and Sales of Mutual Funds* (Working Paper, Nov. 1, 2017) (*see also* Department of Labor April 2019 memo). *See, e.g.*, Bullard et al. (2008), *supra* footnote 1089; Friesen & Sapp (2007), *supra* footnote 1089.

empirical result that broker-sold funds underperform direct-sold funds is subject to another caveat because there is likely to be a selection bias in the type of investor that utilizes the direct-sold fund channel relative to those investors who rely on financial professionals for advice and recommendations about which funds to purchase. A similar selection bias is likely to exist for investors who purchase no-load funds versus those that purchase load funds from financial professionals. For example, although numerous studies discussed above suggest that financial advice is more likely to be obtained by older, more financially sophisticated, and wealthier investors,[1108] Chalmers and Reuter (2015) observe that younger, less financially experienced, and less wealthy investors are more likely to buy broker-sold funds.[1109]

Beyond mutual funds, a nascent literature is emerging on other securities that may be prone to conflicts of interest by financial professionals.[1110] Recent studies have examined

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[1108] *See supra* Section III.B.3.a.

[1109] *See supra* footnote 1042.

[1110] Some commenters (*see*, *e.g.*, CFA August 2018 Letter; AARP August 2018 Letter; EPI Letter) also provided studies about conflicts of interest in 401(k) plans which have shown that (i) plan sponsors tilt securities toward high-cost securities (*see* Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and "Dominated Funds" in 401(k) Plans*, 124 YALE L.J. 1476 (2015)); (ii) plans have inadequate or excessive investment choices (*see* Edwin J. Elton, Martin J. Gruber, & Christopher R. Blake, *The Adequacy of Investment Choices Offered by 401(K) Plans*, 90 J. PUB. ECON. 1299 (2006); Sheena Sethi-Iyengar, Gur Huberman, & Wei Jiang, *How Much Choice is Too Much? Contributions to 401(k) Retirement Plans*, *in* PENSION DESIGN AND STRUCTURE: NEW LESSONS FROM BEHAVIORAL FINANCE (Olivia S. Mitchell & Stephen P. Utkuss eds., 2004)); (iii) plans may include proprietary funds even when other funds perform better (*see* Veronika K. Pool, Clemens Sialm, & Irina Stefanescu, *It*

potential conflicts of interest in markets for more complex investments, including reverse convertible corporate bonds and non-traded REITs. One study uses a sample of reverse convertible corporate bonds that differ only in the financial incentives provided to financial professionals and the coupon rate, and finds that investors are more likely to purchase—based on the advice given—the inferior bond (lower coupon, all else equal) with the higher "kick-back" to the broker-dealer, which appears to be driven by conflicts of interest between the financial professional and the investors.[1111] In an examination of non-traded REITs, one study documents that retail investors in non-traded REITs underperformed by over $45 billion relative to a portfolio of traded REITs, and that nearly one-third of that underperformance was driven by upfront fees used to compensate broker-dealers.[1112]

Finally, although a significant amount of empirical evidence suggests that there may be investor harm due to conflicts of interest between financial professionals and investors, because

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Pays to Set the Menu: Mutual Fund Investment Options in 401(K) Plans, 71 J. FIN. 1779 (2016)); and (iv) funds included in 401(k) plans underperform passive benchmarks by approximately 31 bps annually (*see* Edwin J. Elton, Martin J. Gruber, & Christopher T. Blake, *How do Employer's 401(K) Mutual Fund Selections Affect Performance?*, Ctr. for Retirement Research at Bos. Coll., Issue in Brief No. 13-1 (Jan. 2013), *available at* https://crr.bc.edu/wp-content/uploads/2013/01/IB_13-1-508.pdf).

1111 *See* Egan (2019), *supra* footnote 1068.

1112 *See* Craig McCann, *Fiduciary Duty and Non-Traded REITs*, INVESTMENTS & WEALTH MONITOR, July/Aug. 2015, at 39, *available at* https://www.slcg.com/pdf/workingpapers/Fiduciary%20duty%20and%20Non-traded%20REITs.pdf. *See* CFA August 2018 Letter.

of changes to the mutual fund industry (e.g., shifts from load to no-load funds and the introduction of new share classes),[1113] increased competition,[1114] and the anticipation of regulation designed to ameliorate potential conflicts of interest, several new studies indicate that potential harm to investors arising from conflicts of interest may be declining.[1115] One survey paper concludes that although the empirical evidence is consistent with financial professionals having conflicts of interest that may harm consumers, "none of the articles concludes that clients would have been better off by foregoing advice. Even if people receive lower returns… consulting with an advisor may provide intangible benefits that consumers value," and "it is important to bear in mind that these studies may have data limitations and in general cannot

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[1113] *See* ICI Letter and Holden et al. (2018), *supra* footnote 951. *See also* Capital Group Letter; Money Management Institute Letter; FPC Letter at footnote 73. As noted above, innovations, including the introduction of T and clean share classes of funds may reduce the expected fund underperformance net of costs for retail investors relative to A shares by nearly 50 basis points annually. *See supra* footnote 1021 and accompanying text. *See also supra* footnote 1020 and accompanying text.

[1114] *See* LPL December 2018 Letter; Morgan Stanley Letter (which discuss the migration to open architecture platforms).

[1115] *See* Reuter (2015), *supra* footnote 1042; Sethi et al. (2019), *supra* footnote 1093. *See also* CFA August 2018 Letter; EPI Letter; Morningstar Letter; Morningstar Letter Supplement. We include recent studies provided by commenters to present the current baseline of empirical findings on potential investor harm stemming from conflicts of interest.

account for selection issues and the intangible benefits that investors receive from financial advisors."[1116]

4. Trust, Financial Literacy, and the Effectiveness of Disclosure

A number of commenters stated that the Proposing Release did not sufficiently address how issues related to trust in financial professionals, investors' level of financial literacy or sophistication, and limitations on the effectiveness of disclosure likely exacerbate the problems of information asymmetry and potential conflicts of interest between retail investors and financial professionals.[1117] In order to address commenters' concerns, we examined and discuss below both academic and industry research on how trust and financial literacy could affect the recommendations provided by financial professionals to retail investors, as well as the effectiveness and limitations of disclosure in ameliorating potential conflicts of interest.

a. Trust in Investment Advice

In seeking financial advice, a retail investor places not only money but also trust in a financial professional. Commenters stated that retail investors will follow the advice of their

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[1116] *See* Burke et al. (2015), *supra* footnote 1059. The DOL RIA, *supra* footnote 1002, and some commenters, however, have stated that no advice is a better alternative to advice subject to conflicts of interest. *See also* EPI Letter; Betterment Letter; PIABA Letter; CFA August 2018 Letter. The DOL RIA suggests that investors who obtain advice subject to conflicts of interest are worse off due to the costs associated with obtaining such advice (e.g., underperformance) than had they not sought or received advice at all.

[1117] *See* AARP August 2018 Letter; CFA August 2018 Letter; FPC Letter; Rhoades December 2018 Letter; EPI Letter.

"trusted advisors," because they believe "financial professional[s] will place the investor's financial interest before his or her own."[1118] Moreover, one industry study of over 800 investors notes that "96% of U.S. investors report that they trust their financial professional and 97% believe their financial professional has their best interest in mind."[1119] Academic studies have explored the issue of trust and how it affects financial decisions of investors. Studies in this strand of academic literature find that higher levels of trust increase investors' propensity to seek investment advice and hire financial professionals,[1120] increase levels of stock market

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[1118] *See* Letter from Christine Lazaro, President, PIABA (Dec. 7, 2018) ("PIABA December 2018 Letter"). *See also, e.g.*, Rhoades December 2018 Letter; Gross Letter; Letter from William W. McGinnis, W. McGinnis Advisors (Aug. 7, 2018) ("McGinnis Letter"); EPI Letter; Betterment Letter; State Attorneys General Letter; Better Markets August 2018 Letter; OIAD/RAND (providing a survey on academic literature on trust). One survey notes, however, that approximately 15% of survey participants do not consult with financial professionals because they "don't trust them." *See* Cetera November 2018 Letter.

[1119] *See* CCMC Letters. *See also* Center for Capital Markets Competitiveness, *Working with Financial Professionals: Opinions of American Investors* (2018), *available at* https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/CCMC_InvestorPolling_v5-1.pdf.

[1120] *See* Jeremy Burke & Angela A. Hung, *Trust and Financial Advice* (RAND Labor & Population, Working Paper No. WR-1075, Jan. 2015), *available at* https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/proposed-regulations/1210-AB32-2/trust-and-financial-advice.pdf. This study indicates that increased financial trust is associated with higher levels of both seeking and following investment advice. *See also* AARP August 2018 Letter; FPC Letter; CFA August 2018 Letter.

participation,[1121] and increase willingness to take on higher-risk investments.[1122] Regarding the importance of trust in established advice relationships, some studies find that trust in financial professionals is greater when investors have lower financial literacy or when purchasing complex products, such as insurance products.[1123] Further, as trust in financial professionals grows, investors may be more likely to delegate all investment decisions to the financial professional, irrespective of their level of financial education.[1124]

[1121] *See* Luigi Guiso, Paola Sapienza, & Luigi Zingales, *Trusting in the Stock Market*, 63 J. FIN. 2557 (2008). Guiso et al. (2008) find that higher levels of trust in financial professionals by investors is associated with a 50% increase in the probability of buying stocks and a 3.4% increase in the proportion of equity investments in the aggregate portfolio. *See* Rhoades December 2018 Letter.

[1122] *See* Nicola Gennaioli, Andrei Shleifer, & Robert Vishny, *Money Doctors*, 70 J. FIN. 91 (2015). This study suggests that increased trust in financial professionals by investors alleviates anxiety in undertaking higher-risk investments (e.g., equities) (included because they capture aspects of the benefits of higher levels of trust in financial professionals by retail investors that are not captured by the studies suggested by the commenters).

[1123] *See* Thomas Pauls, Oscar Stolper, & Adreas Walter, *Broad-Scope Trust and Financial Advice* (Working Paper, Nov. 17, 2016), *available at* https://www.researchgate.net/publication/314235638_Broad-scope_trust_and_financial_advice; David de Meza, Bernd Irlenbusch, & Diane Reyniers, *Disclosure, Trust and Persuasion in Insurance Markets* (IZA Discussion Paper Series, No. 5060, July 2010), *available at* http://repec.iza.org/dp5060.pdf. *See also* OIAD/RAND, which shows that investors most likely in need of investor protection (e.g., financially unsophisticated) are most likely to place their trust in financial professionals. *See also* Letter from AFL-CIO et al. (Dec. 7, 2018) ("AFL-CIO December 2018 Letter").

[1124] *See* Riccardo Calcagno, Maela Giofre, & Maria Cesira Urzi-Brancati, *To Trust is Good, but to Control is Better: How Investors Discipline Financial Advisors' Activity*, 140 J. ECON. BEHAV. & ORG. 287 (2017). *See* OIAD/RAND.

Several commenters stated that some financial professionals respond to the trust that retail investors place in them by acting on their conflicts of interest, which could benefit the financial professional at the expense of the investor.[1125] In addition, some studies have shown that higher levels of trust by retail investors can provide incentives for financial professionals to provide conflicted investment advice or undertake actions that benefit themselves at the expense of their customers. For example, one study found that because investors trust their financial professionals to provide higher ex ante expected returns on their risky investments, firms employing those professionals increased fees above levels that, in the author's view, were consistent with a competitive equilibrium, resulting in lower ex post net returns to investors.[1126] Further, this study documents that, although a relationship with a trusted professional can encourage investors to invest in financial markets when it is efficient for them to do so, in some cases financial professionals may instead provide more conflicted investment advice or inefficient advice in order to satisfy the desires of investors who trust them (e.g., undertaking lottery-like behavior by investing in the riskiest securities).[1127] Although trust in financial professionals can help alleviate certain behavioral biases and encourage participation in the securities markets, one commenter stated that "[r]etail customers who place their trust in

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1125 *See, e.g.*, Rhoades December 2018 Letter; EPI Letter; Better Markets August 2018 Letter.

1126 *See* Calcagno et al. (2017), *supra* footnote 1124.

1127 *See id.*

salespeople that market services as acting in their best interest can end up paying excessively high costs for higher risk or underperforming investments that only satisfy a suitability standard, not a fiduciary standard." [1128]

b. Financial Literacy and Investment Advice

As discussed above, financial literacy affects those who seek investment advice from financial professionals. One commenter noted that "[a]s consumers move closer to retirement, they may be more vulnerable to the negative impact of advice that is not in their best interest for three reasons: (1) the assets they have to invest are larger; (2) they may lack strong financial literacy skills; and (3) reduced cognition may affect financial decision making."[1129] A number of studies have shown that financial literacy is significantly related to retirement planning and wealth accumulation by retail investors.[1130] Generally, studies find that investors who are more financially literate or sophisticated are more likely to seek investment advice and are more likely

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1128 *See* AARP August 2018 Letter. *See also* PIABA Letter; St. John's U. Letter. *See also* Joseph C. Peiffer & Christine Lazaro, *Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty*, PIABA Report (Mar. 25, 2015), *available at* https://piaba.org/sites/default/files/newsroom/2015-03/PIABA%20Conflicted%20Advice%20Report.pdf.

1129 *See* AARP August 2018 Letter.

1130 *See, e.g.*, Jere R. Behrman et al., *Financial Literacy, Schooling, and Wealth Accumulation* (Nat'l Bureau of Econ. Research, Working Paper No. 16452, Oct. 2010), *available at* https://www.nber.org/papers/w16452.pdf; Hans-Martin von Gaudecker, *How Does Household Portfolio Diversification Vary with Financial Literacy and Financial Advice?*, 70 J. FIN. 489 (2015) (included in response to comment letters that expressed views about limited financial literacy by some retail investors).

to follow that advice than less financially sophisticated investors.[1131] Further, one study shows that investors with lower financial literacy who do not seek investment advice underperform investors with higher financial literacy who seek investment advice by more than 50 bps on average, and these losses are predominantly driven by under-diversification of their portfolios.[1132]

A number of studies link retail investor demographic characteristics to financial literacy and document that financial illiteracy, although widespread, is most significant among investors with lower levels of educational attainment, women, and minorities.[1133] Moreover, many studies have examined the relationship between age, cognition, and financial literacy, and have shown that older investors, on average, are the least likely to be financially literate, and that financial

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1131 *See supra* Section III.B.3. *See also* Riccardo Calcagno & Chiara Monticone, *Financial Literacy and the Demand for Financial Advice*, 50 J. BANKING & FIN. 363 (2015), who observe that investors with lower levels of financial literacy are less likely to consult advisers and avoid risky assets; however, when they do seek advice, they generally delegate investment decisions to their financial professionals. Lusardi & Mitchell (2011) indicate that investors who are more financially sophisticated are more likely to plan for wealth accumulation and be successful in their planning. *See* Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy and Planning: Implications for Retirement Wellbeing* (Nat'l Bureau of Econ. Research, Working Paper No. 17078, May 2011), *available at* https://www.nber.org/papers/w17078.pdf. *See* AARP August 2018 Letter.

1132 *See* von Gaudecker (2015), *supra* footnote 1130. This study finds that losses borne by investors with lower financial literacy are predominantly driven by under-diversification of their portfolios.

1133 *See* Lusardi & Mitchell (NBER 2011), *supra* footnote 1131. *See also* Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy and Retirement Planning in the United States*, 10 J. PENSION ECON. & FIN. 509 (2011). *See* AARP August 2018 Letter.

literacy degrades as investors age.[1134] A number of these studies show, however, that investors with low levels of financial literacy are likely to be over-confident in their financial abilities. For example, several studies that explore the relationship between age and financial literacy show that confidence in financial decision making does not decline with age, and potentially leads to poor decisions (e.g., paying higher mortgage rates).[1135] Although over-confident investors with low levels of financial literacy could potentially benefit most from seeking and following investment advice, one study shows that over-confident investors are less likely to seek advice and perceive it as less valuable.[1136]

One potential problem, however, for investors with lower financial literacy is that they may not be able to distinguish the quality of their financial professional or the advice that they

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1134 *See* Michael S. Finke, John Howe & Sandra J. Huston, *Old Age and Decline in Financial Literacy* (Working Paper, Aug. 24, 2011), who document that financial literacy scores decline by approximately 1% each year over the age of 60. *See also* Annamaria Lusardi, Olivia S. Mitchell, & Vilsa Curto, *Financial Literacy and Financial Sophistication Among Older Americans* (Nat'l Bureau of Econ. Research, Working Paper No. 15469, Nov. 2009), *available at* https://www.nber.org/papers/w15469.pdf; Keith Gamble et al., *Aging and Financial Decision Making*, 61 MGMT. SCI. 2603 (2015). *See* AARP August 2018 Letter.

1135 *See* Finke et al. (2011) and Gamble et al. (2015), *supra* footnote 1134.

1136 *See* Marc M. Kramer, *Financial Literacy, Overconfidence and Financial Advice Seeking* (Working Paper, Dec. 19, 2014), *available at* https://efmaefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2015-Amsterdam/papers/EFMA2015_0067_fullpaper.pdf.

receive.[1137] One study documents that small traders, relative to large institutional investors, are unable to recognize biases in recommendations provided by securities analysts, and therefore follow analyst recommendations to buy and sell securities without considering other information produced by the analyst.[1138] Additionally, financial literacy may influence the quality of advice that financial professionals are willing to provide their clients. Some financial professionals appear to be more likely to provide superior information to more financially literate investors, who may be able to discern the quality of the advice, and more likely to provide inferior and potentially more conflicted information to investors who are less financially literate.[1139]

c. Evidence on the Effectiveness and Limitations of Disclosure

Regulation Best Interest relies in part on disclosure of certain material facts to retail customers.[1140] A number of commenters, however, stated that we failed to sufficiently account

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1137 *See* Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197 (2008). *See* AARP August 2018 Letter.

1138 *See* Ulrike Malmendier & Devin Shanthikumar, *Are Small Investors Naive About Incentives?*, 85 J. FIN. ECON. 457 (2007). *See* AARP August 2018 Letter.

1139 *See* Willis (2008), *supra* footnote 1137, and Calcagno & Monticone (2015), *supra* footnote 1131. *See also* John A. Turner, Bruce W. Klein, & Norman P. Stein, *Financial Illiteracy Meets Conflicted Advice: The Case of Thrift Savings Plan Rollovers* (Working Paper, Apr. 2015), *available at* https://gflec.org/wp-content/uploads/2015/04/Turner-0408Assessing-the-Standard-for-Financial-Advice.pdf, which documents that financial professionals often suggest rolling over from thrift savings plans to more expensive plans (e.g., IRAs), and that such behavior is pervasive among both broker-dealers and investment advisers. *See* AARP August 2018 Letter.

1140 *See supra* Section II.C.1.

for limitations of disclosure in the Proposing Release of Regulation Best Interest.[1141] One commenter stated that "studies show that regulation by disclosure alone can actually undermine investor protection by emboldening advisers to ignore the client's best interest once they have 'checked the disclosure box,' and by rendering investors even more vulnerable to conflicted advice once they receive disclosures."[1142] Another commenter asserted that the ineffectiveness of disclosure arises because of investors' failure to understand the disclosure, inadequate time to read and process the information, cognitive dissonance, and trust in financial professionals' oral representations over written disclosures, among others.[1143] Below, we discuss studies that have identified characteristics that make disclosure effective as well as limitations to the effectiveness of disclosure to investors, in particular focusing on issues related to disclosure of conflicts of interest and how disclosure could inflate potential conflicts between financial professionals and investors.

Characteristics of effective disclosures include saliency of information, clear and concise information delivered in a transparent manner, and increased use of visual and interactive design,

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1141 *See* AARP August 2018 Letter; Better Markets August 2018 Letter; State Attorneys General Letter; EPI Letter; Morningstar Letter; Warren Letter; UVA Letter.

1142 *See* Better Markets August 2018 Letter. *See infra* footnote 1148 for studies submitted by this commenter.

1143 *See* State Attorneys General Letter. *See also* EPI Letter.

among others.[1144] One study, examining the effect of disclosure of fees and costs for mutual funds, observes that disclosures that prominently feature fees are more effective than others, but do not appear to reduce the importance that investors place on other fund characteristics, such as performance or risk.[1145] Other studies, however, have found that disclosures may be ineffective, particularly if the intended audience does not read the disclosure documents or does not understand the material presented to them. One study, for example, notes that as the length and complexity of the disclosure document increases, so does the time that it takes for investors to read and understand the material contained within; therefore, investors are more likely to prefer shorter, simpler, and more straightforward language in disclosures.[1146]

[1144] *See* Relationship Summary Adopting Release at Section IV, which also discusses the benefits and limitation of disclosure. *See also* Margaret Hagan, *Designing 21st Century Disclosure Methods for Financial Decision Making*, Stanford Law School Policy Lab (2016), *available at* https://law.stanford.edu/publications/designing-21st-century-disclosures-for-financial-decision-making/. One study finds that when fund expenses are bundled with brokerage commissions, reducing the transparency of various fees and costs, investors experience larger degrees of underperformance than when the fees are more transparent. *See* Roger M. Edelen, Richard B. Evans, & Gregory B. Kadlec, *Disclosure and Agency Conflict: Evidence from Mutual Fund Commission Bundling*, 103 J. FIN. ECON. 308 (2012). *See* AARP August 2018 Letter.

[1145] *See* Lucy Hayes, William Lee, & Anish Thakrar, *Now You See It: Drawing Attention to Charges in the Asset Management Industry* (Fin. Conduct Auth., Occasional Paper No. 32, Apr. 2018), *available at* https://www.fca.org.uk/publication/occasional-papers/occasional-paper-32.pdf. *See* Morningstar Letter. *See also* Anagol et al. (2015), *supra* footnote 1075.

[1146] *See* Tamar Frankel, *The Failure of Investor Protection by Disclosure*, 81 U. CIN. L. REV. 421 (2013). *See* FPC. *See also* Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647 (2011), which also questions the

Many studies have explored the effect of revealing conflicts of interest to consumers and note that disclosure of conflicts may produce undesirable behavior by the disclosing party, or that receivers of the information provided by disclosures may fail to appropriately account for the implications.[1147] A series of studies documents that consumers do not account for conflicts of interest revealed through disclosures, and that such disclosures of conflicts can have the perverse effect of increasing bias and moral licensing in the provision of advice.[1148] Moral licensing arises when the discloser of information "take[s] an ethical action that validates [her] self-image as a good person" so she feels as though she "may well give [herself] permission to

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effectiveness of disclosures and finds mandated disclosures ineffective substitutes for more direct regulation. *See* AARP August 2018 Letter; Better Markets August 2018 Letter; State Attorneys General Letter.

1147 *See also* Relationship Summary Adopting Release.

1148 *See* Daylian M. Cain, George Loewenstein, & Don A. Moore, *When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest*, 37 J. CONSUMER RES. 836 (2011); Daylian M. Cain, George Loewenstein, & Don A. Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1 (2005); George Loewenstein, Daylian M. Cain & Sunita Sah, *The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest*, 101 AM. ECON. REV. (PAPERS & PROC.) 423 (2011). These studies also note that, although disclosure is intended to help financially unsophisticated consumers, disclosure is most likely to be beneficial to sophisticated users of the information. One study, however, notes that disclosure can reduce biased advice if the disclosure acts as a deterrent against entering into conflicts, and may improve trust in advisers. *See* Sunita Sah & George Loewenstein, *Nothing to Declare: Mandatory and Voluntary Disclosure Leads Advisors to Avoid Conflicts of Interest*, 25 PSYCH. SCI. 575 (2014). *See also* Morningstar Letter; EPI Letter; Better Markets August 2018 Letter; Warren Letter; UVA Letter; AARP August 2018 Letter; Johnsen Letter.

play fast and loose with the rules for a while."[1149] Disclosure may also lead to a decrease in trust of biased advice because consumers feel pressured to satisfy the discloser's self-interest ("panhandler effect");[1150] however, the panhandler effect can be mitigated if the disclosure is provided from an external source, the disclosure is not common knowledge between the discloser and the receiver of the information, the receiver can change his or her mind at a later date, and the receiver can change his or her mind in private.[1151] One study notes that, beyond conflicts disclosures, disclosures of actual bias lead to an improvement in performance of portfolios relative to investors who only receive conflict disclosures.[1152]

From the perspective of the investor, conflicts disclosures may lead to under- or over-reaction by investors. According to one study, investors may not know how to appropriately

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1149 *See* Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 WIS. L. REV. 1059 (2011). *See* AARP August 2018 Letter; Better Markets August 2018 Letter; State Attorneys General Letter.

1150 *See* Cain et al. (2011), *supra* footnote 1148; Sunita Sah, Prashant Malaviya, & Debora Thompson, *Conflict of Interest Disclosure as an Expertise Cue: Differential Effects of Automatic and Deliberative Processing*, 147 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 127 (2018), whereby disclosures of conflicts of interest act "as a heuristic cue to infer greater trust in advisors' expertise."

1151 *See* Sunita Sah, George Loewenstein, & Daylian M. Cain, *The Burden of Disclosure: Increased Compliance With Distrusted Advice*, 104 J. PERSONALITY & SOC. PSYCHOL. 289 (2013). *See* Morningstar Letter; Better Markets August 2018 Letter; EPI Letter.

1152 *See* Christopher Tarver Robertson, *Biased Advice*, 60 EMORY L.J. 653 (2011). This study also suggests that obtaining an opinion from an unbiased adviser "is a much better remedy for biased advice than disclosure." *See* AARP August 2018 Letter.

respond to information about conflicts (e.g., estimating the effects on the quality of advice or knowing how to search for an unbiased second opinion) and therefore may fail to adequately adjust their behaviors when conflicts are disclosed.[1153] Alternatively, some investors may overreact to disclosures of conflicts of interest, and may instead forgo valuable investment advice.[1154]

C. Benefits and Costs

1. General

In formulating Regulation Best Interest, the Commission has considered the potential benefits of establishing a best interest standard of conduct for broker-dealers, as well as the potential costs.

[1153] *See* Angela A. Hung, Min Gong, & Jeremy Burke, *Effective Disclosures in Financial Decisionmaking*, RAND Labor and Population Report Prepared for the Department of Labor (2015), *available at* https://www.rand.org/content/dam/rand/pubs/research_reports/RR1200/RR1270/RAND_RR1270.pdf. *See also* AARP August 2018 Letter; Better Markets August 2018 Letter; Warren Letter. *See also* James M. Lacko & Janis K. Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment*, Federal Trade Commission, Bureau of Economics Staff Report (Feb. 2004), *available at* https://www.ftc.gov/sites/default/files/documents/reports/effect-mortgage-broker-compensation-disclosures-consumers-and-competition-controlled-experiment/030123mortgagefullrpt.pdf, which documents that when mortgage customers receive information about mortgage broker compensation through disclosures, such disclosures lead to an increase in more expensive loans and create a bias against broker-sold loans, even when the broker-sold loans are the more cost effective option. *See* EPI Letter.

[1154] *See* George Loewenstein, Cass R. Sunstein, & Russell Golman, *Disclosure: Psychology Changes Everything*, 6 ANN. REV. ECON. 391 (2014). *See* IRI Letter.

Regulation Best Interest enhances the broker-dealer standard of conduct beyond existing suitability obligations, and aligns the standard of conduct with retail customers' reasonable expectations. Under Regulation Best Interest, broker-dealers and their associated persons will be required, among other things, to: (1) 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 ahead of the interests of the retail customer; and (2) address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest, and in instances where we have determined that disclosure is insufficient to reasonably address the conflict, to mitigate or, in certain instances, eliminate the conflict. As a result, Regulation Best Interest should enhance the efficiency of recommendations that broker-dealers provide to retail customers, help retail customers evaluate the recommendations received, and improve retail customer protection when receiving recommendations from broker-dealers. The four component obligations of Regulation Best Interest's work together to enhance the current standard of conduct for broker-dealers and improve disclosure of material facts relating to the scope and terms of the relationship and conflicts of interest. Both on its own and together with the other new rules and forms we are adopting,[1155] we anticipate that Regulation Best Interest will reduce the agency costs of the

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[1155] *See, e.g.*, Relationship Summary Adopting Release.

relationship between the associated persons of the broker-dealer and their retail customers, while preserving access to financial advice and choice in the scope of services and how to pay for them.

In this section, we discuss broader themes associated with the costs and benefits of Regulation Best Interest, including general comments we received on our analysis of the costs and benefits in the Proposing Release. Following this more general discussion, we discuss the specific costs and benefits associated with Regulation Best Interest's four component obligations.

While the Commission has considered the potential benefits and costs of Regulation Best Interest, the Commission notes that generally it is difficult to quantify such benefits and costs with meaningful precision.[1156] Where possible, the Commission has provided an estimate of specific costs; however, several factors make the quantification of many of the effects of Regulation Best Interest difficult. With respect to costs to broker-dealers, 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. Also, the final rule will provide broker-dealers flexibility in complying with Regulation Best Interest, and, as a result, there could be multiple ways in which broker-dealers will satisfy this obligation, although broker-dealers must comply with each of the elements of the obligation. In addition, Regulation Best Interest may

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1156 *See supra* Section III.B.3.c for discussion of the wide range of estimates of the potential benefits of Regulation Best Interest stemming from a reduction in investor harm, and discussion surrounding *infra* footnotes 1165-1182 for other issues associated with these estimates.

affect broker-dealers differently depending on their business model (e.g., full service broker-dealer, broker-dealer that uses independent contractors, insurance-affiliated broker-dealer) and size. More generally, estimates of the magnitude of such benefits and costs depend on assumptions about (1) the extent to which broker-dealers currently engage in disclosure and conflict mitigation activities, (2) how broker-dealers currently develop recommendations for their customers, (3) how broker-dealers choose to comply with Regulation Best Interest, (4) whether and how broker-dealers change investments and share classes offered as a result of Regulation Best Interest, (5) whether and how product manufacturers change their investment offerings as a result of Regulation Best Interest, (6) whether broker-dealers restrict access to brokerage accounts by raising minimum account sizes or adding additional qualification requirements, (7) whether broker-dealers try to shift customers to advisory accounts as a result of Regulation Best Interest, (8) how retail customers perceive the risk and return of their portfolios, (9) how likely retail investors are to act on a recommendation that complies with Regulation Best Interest, (10) how the risk and return of retail customer portfolios change as a result of how they act on the recommendation, and (11) how investment advisers, including dually registered advisers, react to the adoption of Regulation Best Interest and the other regulatory developments, including the rules we are adopting and interpretations we are issuing simultaneously with Regulation Best Interest. Because many of these factors are firm-specific and thus inherently difficult to quantify, even if it were possible to calculate a range of potential quantitative estimates, that range would be so wide as to not be informative about the magnitude of the benefits or costs associated with Regulation Best Interest.

Broader economic forces, beyond broker-dealer and retail customer behavioral responses to Regulation Best Interest, also make meaningful estimates of economic impacts difficult to

develop. The market for investment advice and services is complex and vast, and as history demonstrates, is dynamic and affected by market-specific facts (including product developments and regulatory changes) as well as macroeconomic factors (including general economic conditions). For example, the introduction of indexation to the retail investment market and the subsequent increase in index products (and providers) and reduction in the costs of indexing for retail investors have had substantial effects on the market for retail investment advice and services. The more recent introduction of ETFs has had similar unanticipated and underestimated effects, including, in general, reducing investor costs and increasing tax efficiency, as well as increasing the array of product offerings. Developments such as the employer-driven shift from defined benefit plans to defined contribution plans also have had significant effects on the market for investment advice. We expect these and other factors, including factors not currently identified, will continue to affect the market and, accordingly, may change the economic effects of the rule. These sources of uncertainty and complexity make meaningfully quantifying many of the costs and benefits of the rule difficult and, particularly over long time periods, inherently speculative.

a. Broad Commenter Concerns with Respect to Costs and Benefits

We received many comments regarding our analysis in the Proposing Release of the benefits and costs. In this section, we discuss comments that address broader aspects of our

analysis. Comments that address costs and benefits of more specific components of Regulation Best Interest are discussed in the corresponding sections for each rule component that follows.

Some commenters stated that our analysis in the Proposing Release did not properly incorporate current market practices into the baseline.[1157] As discussed above, we have revised the discussion to include those practices, which may reflect guidance by SROs such as FINRA, requirements and obligations under state laws, practices implemented by broker-dealers in response to the (now vacated) DOL Fiduciary Rule that have not been reversed, and any practices implemented by broker-dealers to fulfill their obligations under existing federal securities laws.[1158] While we acknowledged in the Proposing Release that variation in the extent to which broker-dealers with different business practices already engage in disclosure and conflict mitigation activities makes quantifying Regulation Best Interest's costs and benefits with meaningful precision difficult, we more explicitly emphasize how this variation in current market practices affects the costs and benefits of Regulation Best Interest in the discussion that follows.[1159] In general, to the extent that broker-dealer practices are already aligned with the requirements of Regulation Best Interest, the anticipated magnitude of both the costs and the benefits associated with a given component of Regulation Best Interest will be correspondingly reduced, and vice versa.

1157 *See, e.g.*, CFA August 2018 Letter; CCMC Letters.

1158 *See supra* Section III.B.2.

1159 *See* Proposing Release at 21643.

As discussed above,[1160] commenters noted the existence of fiduciary standards in various states. One commenter provided an overview of the fiduciary obligations of state-registered investment advisers, "typified by an expectation of undivided loyalty where the adviser acts primarily for the benefit of its clients."[1161] This commenter also stated that "[s]ome states also extend these fiduciary obligations beyond investment advisers to brokers, especially in dual-hatted scenarios," and that these fiduciary obligations were extended even when broker-dealers handled non-discretionary accounts.[1162] We recognize that there is substantial variation in the sources, scope, and application of state fiduciary law. And we acknowledge that such state-level obligations for broker-dealers mean that they may already engage in practices under the baseline that overlap with certain requirements under Regulation Best Interest. To the extent that state-level law incorporates fiduciary principles similar to those reflected in Regulation Best Interest, the magnitude of the costs and benefits discussed below that stem from the application of those principles to broker-dealers will be correspondingly reduced. However, costs and benefits that arise from obligations under Regulation Best Interest that differ from obligations under state law, such as the Conflict of Interest Obligation, will be maintained.[1163]

1160 *See supra* Section III.B.2.

1161 *See* NASAA February 2019 Letter at 22 and footnote 40.

1162 *Id.* at 23-24.

1163 Whether Regulation Best Interest would have a preemptive effect on any state law would be determined in future judicial proceedings, and would depend on the language and operation of the particular state law at issue. We considered whether we could determine

Some commenters suggested that certain types of costs should remain outside the scope of our analysis. Some stated that our analysis should not consider, for example, costs to broker-dealers resulting from lost revenues on securities they cease offering or costs associated with any potential increase in arbitration claims as a result of Regulation Best Interest, except to the extent that they are passed on to investors in the form of higher fees.[1164] These commenters suggested that because these types of costs are a direct result of policies that make investors better off, they should not factor into an assessment of Regulation Best Interest. The Commission has an obligation to consider the economic effect of Regulation Best Interest on affected parties, including broker-dealers, even when those costs are associated with benefits to investors. However, in the specific discussion of each rule component that follows, we highlight instances where a given cost is directly associated with a benefit to investors.

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the economic impact of possible, future state-law preemption on retail customers, but concluded that we cannot analyze the economic effects of the possible preemption of state law at this point because the factors that will shape those judicial determinations are too speculative. Among the unknown factors are: (1) the final language in any proposed state legislation or regulation adopting a fiduciary or other standard for broker-dealers; (2) whether that language would constitute the type of law, rule, or regulation that is expressly preempted by the securities law or impliedly preempted under principles applied by courts; and (3) whether, if there was preemption, that preclusion of state law would have any positive or negative effects on investors when compared with the economic effects of Regulation Best Interest.

1164 *See* AARP August 2018 Letter; EPI Letter; Better Markets August 2018 Letter; Cetera August 2018 Letter.

Commenters raised several issues related to the quantification of costs and benefits, or lack thereof, in the Proposing Release. They asserted that our analysis focused too much on Regulation Best Interest's costs and did not quantify any of the benefits, such as the reduction in investor harm.[1165] As discussed above, some studies present anecdotal evidence of behavior by certain broker-dealers, such as recommending investments that are inferior to available alternatives, that is harmful to investors.[1166] A potential benefit of Regulation Best Interest is therefore a reduction in that harm, as asserted by commenters. However, the anecdotal evidence of investor harm in these studies does not lend itself to aggregation.

Commenters also stated that we should have incorporated the approach used by the DOL RIA and the CEA to quantify aggregate investor harm.[1167] While both of these analyses surveyed a broad literature on the relative performance of broker-sold versus direct-sold mutual funds, they both relied on a particular study to estimate aggregate investor harm, extrapolating the effect of "excess loads" on the performance of broker-sold funds to total industry-wide AUM.[1168] We disagree with this approach because, as noted by commenters, we believe these

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1165 *See* AARP August 2018 Letter; Better Markets August 2018 Letter; CFA August 2018 Letter.

1166 *See supra* footnotes 1068 and 1075.

1167 *See* Better Markets August 2018 Letter.

1168 *See supra* footnotes 1081 and 1099.

analyses misapplied the particular study's results.[1169] When the results of the study are correctly applied, the aggregate estimate of investor harm obtained using this approach is negligible.[1170]

Another commenter advocated a similar approach, claiming that risk-adjusted returns net of fees, which calculate the excess return of an investment above a benchmark that matches the risk of the investment, are the only appropriate measure of whether a recommendation is in a retail customer's best interest.[1171] While there are studies showing that broker-sold mutual funds underperform direct-sold funds to varying degrees,[1172] we do not believe, for the reasons explained below, that applying estimates of this under-performance to industry-wide AUM produces a meaningful estimate of the aggregate investor harm attributable to recommendations made by broker-dealers that is sufficiently precise to inform our policy choices. First, as discussed above, these studies do not necessarily cleanly distinguish under-performance attributable to broker-dealers from under-performance attributable to investment advisers.[1173]

Second, interpreting the relative underperformance of broker-sold funds as a measure of investor harm due to conflicts of interest implicitly evaluates investor harm against a benchmark

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1169 *See, e.g.*, Lewis (2017), *supra* footnote 1099.

1170 *See id.*

1171 *See* EPI Letter. *See also* Former SEC Senior Economists Letter, stating that risk-adjusted returns are an appropriate measure of investor harm.

1172 *See, e.g.*, Bergstresser et al. (2009), *supra* footnote 1048; Del Guercio & Reuter (2014), *supra* footnote 1081.

1173 *See supra* footnote 1097.

that does not include financial advice. However, that benchmark does not necessarily reflect the appropriate alternative available to investors in broker-sold funds. Extrapolating from these studies leads to the conclusion that investors would do better investing *on their own*, yet there are other studies showing that is not the case, at least not for all investors.[1174] We further note that calculating the investor harm against a benchmark that includes the fees retail customers would pay for equivalent advice could significantly reduce the magnitude of these estimates.[1175]

Finally, while risk-adjusted returns may be useful in comparing the performance of particular mutual funds, particularly when trying to evaluate fund manager skill, they do not necessarily reflect the utility that investors achieve from their investments.[1176] Heterogeneous investors value investments and the services provided by financial professionals differently depending on their investment profile and preferences, and risk-adjusted returns do not necessarily represent aggregate utility across all investors in a way that permits us to arrive at an aggregate measure of investor harm. For example, consumers invest in various forms of insurance products in order to hedge their exposure to bad outcomes (e.g., home insurance policies), even though the expected returns on such investments are generally negative. The

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1174 *See supra* footnotes 1045-1048.

1175 *See also supra* footnote 1103.

1176 Even in the context of evaluating fund manager skill, there is debate about whether risk-adjusted returns are an appropriate measure of fund performance. *See e.g.*, Vincent Glode, *Why Mutual Funds "Under Perform"*, 99 J. FIN. ECON. 546 (2011); Jonathan B. Berk & Jules H. van Binsbergen, *Measuring Skill in the Mutual Fund Industry*, 118 J. FIN. ECON. 1 (2015).

relative underperformance of broker-sold mutual funds also may not capture any intangible benefits investors derive from receiving tailored financial advice.[1177] Alternatively, the relative performance of mutual funds sold through these two channels may reflect other factors that are unrelated to conflicts of interest.[1178] Accordingly, while we do not dispute the existence of broker-dealer behavior under the baseline that is harmful to investors, based on our analysis, including our analysis of the comments received, we continue to believe that quantifying that harm, and therefore quantifying the benefits associated with reducing it, depends on many contingent factors that would render any estimates insufficiently precise to inform our policy choices.[1179]

With respect to the magnitude of the costs we assessed in the Proposing Release, some commenters asserted that our analysis underestimated the costs of complying with Regulation

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1177 *See, e.g.*, Bergstresser et al. (2009), *supra* footnote 1048, who note that "[o]ne possibility is that brokers provide other intangible benefits, which we cannot measure" when interpreting the relative performance of broker-sold versus direct-sold mutual funds.

1178 *See, e.g.*, The DOL RIA, *supra* footnote 1002, at footnote 473, noting that the relative performance of broker-sold versus direct-sold funds "…is an imperfect measure of the impact of conflicts of interest; other factors, aside from conflicts of interest, affect the relative performance of mutual funds sold through the two distribution channels."

1179 *See* Discussion following footnote 1156 for a discussion of these factors. *See also infra* Section III.C.7, where we have endeavored to estimate some of the potential benefits of Regulation Best Interest based on many assumptions.

Best Interest, though only a few provided estimates of these costs.[1180] Where commenters provided estimates for a specific component of Regulation Best Interest, particularly the Disclosure Obligation, we discuss those estimates when discussing that component of Regulation Best Interest below. Based on its experience with the DOL Rule, one commenter provided a broad estimate of the compliance costs associated with the entire package of rules we proposed, including Regulation Best Interest and Form CRS, indicating that the rule package would entail initial costs of $20 million and ongoing costs of $5 million per year for their firm, but that these costs would be manageable.[1181] Another commenter stated that for a small broker-dealer with $500,000 in net capital, the compliance costs estimated in the Proposing Release could constitute 12% of that net capital, making compliance with Regulation Best Interest burdensome for such broker-dealers.[1182] We acknowledge that the costs of Regulation Best Interest could be more burdensome for small broker-dealers and discuss any corresponding competitive effects in Section III.D.1.

Although the majority of the industry studies provided by commenters focused on the effects of the DOL Fiduciary Rule on broker-dealers and their customers, one industry survey provided information about industry beliefs about potential effects of proposed Regulation Best

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1180 *See* Schwab Letter; ICI Letter; Letter from James J. Angel, Associate Professor of Finance, Georgetown University (Aug. 7, 2018) ("Angel Letter"); LPL August 2018 Letter; NSCP Letter.

1181 *See* Raymond James Letter.

1182 *See* NSCP Letter.

Interest.[1183] The survey consisted of approximately 30 individual financial professionals across a mix of 15 companies providing financial advisory services and products, including broker-dealers and dually registered firms, with $23 trillion in AUM and administration and nearly 79 million investment accounts. All of the participants surveyed stated that it was unlikely that they would reconsider their broker-dealer registration status, while nearly 40% stated that they may alter their investment choices and 35% could alter the services that they offer. With respect to the costs of Regulation Best Interest and Form CRS, approximately 36% of respondents stated that the implementation costs could be between 1% and 5% of annual profits; however, nearly 80% of respondents noted that costs are likely to decline over time.[1184] We note that one of the cost estimates provided by a commenter above is consistent with this range.[1185] One commenter suggested that for firms that offer access to thousands of unique securities, many of which likely

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1183 *See* Center for Capital Markets Competitiveness, *SEC Regulation Best Interest Rule Proposals: Request for Information Analysis*, FTI Consulting Report Presented to the U.S. Chamber of Commerce (Jul. 25, 2018), *available at* https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/08/Reg-BI-Rule-Proposal-Research_8.7.18_FTI-Updated_final.pdf. *See* CCMC Letters. Survey participants also addressed questions related to beliefs regarding investor protection, choices for retail customers, and the standard of conduct for broker-dealers.

1184 One commenter stated that the "costly" recordkeeping requirements described in the Proposing Release "are unnecessary as self-interest will lead firms to keep proof of compliance" and should be eliminated. *See* Angel Letter.

1185 *See supra* footnote 1181. Relative to this commenter's 2018 fiscal year profits, its initial cost estimate of $20 million would represent approximately 2% of annual profits for this firm. *See* https://www.sec.gov/Archives/edgar/data/720005/000072000518000083/rjf-20180930x10k.htm.

have similar strategies (e.g., index mutual funds or ETFs), requiring broker-dealers to "consider reasonably available alternatives offered by the broker-dealer as part of having a reasonable basis for making the recommendation" would make it cost prohibitive for broker-dealers and financial professionals to evaluate the costs associated with "every similar investment product available through the broker-dealer's platform."[1186] Many survey participants, although they believed that the Commission underestimated the aggregate costs of Regulation Best Interest and Form CRS, agreed that the benefits to investors were likely to justify the costs.

Other commenters stated that a number of elements of the Proposing Release potentially could increase litigation exposure for some broker-dealers. For example, one commenter discussed that, because proposed Regulation Best Interest did not "expressly define 'financial incentive'" for purposes of the proposed requirement of policies and procedures designed to disclose and mitigate, or eliminate, conflicts arising from financial incentives, broker-dealers could face challenges to "design and maintain effective compliance programs that appropriately address the conflicts inherent in their particular business models" thereby potentially increasing litigation risks.[1187] Another commenter indicated that, with respect to proprietary products, "[s]tate courts in enforcement actions and in review of such actions" may find it difficult to distinguish the best interest standard for broker-dealers from a fiduciary standard for investment

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1186 *See* LPL December 2018 Letter.

1187 *See* Primerica Letter.

advisers, and may cause certain associated persons of broker-dealers to "shy away from the risks of litigation in this regulatory environment, causing a substantial market contraction away from middle class investors."[1188]

In the Proposing Release, we were able to quantify costs for limited portions of Regulation Best Interest, particularly those stemming from requirements related to document creation for purposes of the Paperwork Reduction Act. While we have updated these estimates in Section IV.B, we continue to believe that it is not possible to meaningfully quantify the full costs and benefits of Regulation Best Interest because such analysis would depend on many contingent factors that render any estimate insufficiently precise to inform our policy choices.[1189] So while we acknowledge, for example, that Regulation Best Interest may impose costs that are a significant portion of the estimate of initial and ongoing costs of $20 million and $5 million by the commenter cited above, we cannot anticipate the associated costs for all firms because of the wide variation in size and scope of business practices across firms as well as the many unknown factors associated with the principles-based nature of Regulation Best Interest. In discussing Regulation Best Interest's component obligations below, we address any estimates provided by commenters where we can and otherwise explain the specific factors that preclude quantifying

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1188 *See* Letter from Douglas M. Ommen, Iowa Insurance Commissioner (Aug. 6, 2018) ("Iowa Insurance Commissioner Letter").

1189 *See* Discussion following footnote 1156 for a discussion of these factors. *See also infra* Section III.C.7, where we have endeavored to estimate some of the potential benefits of Regulation Best Interest based on many assumptions.

the costs of Regulation Best Interest with meaningful precision beyond our Paperwork Reduction Act estimates.

b. Broad Investor Protection Benefits

As discussed above, in addition to any enhancements provided above and beyond current requirements and market practices, each of the component obligations of Regulation Best Interest share features with market best practices under the baseline, as shaped by FINRA's guidance on relevant rules or as described in its Report on Conflicts of Interest. Given this overlap, FINRA, in response to a congressional request, enumerated the ways it believes Regulation Best Interest enhances existing broker-dealer obligations under current FINRA rules.[1190]

In addition to the enhancements that each of Regulation Best Interest's component obligations provide above and beyond existing broker-dealer obligations under the baseline, which we discuss below, Regulation Best Interest increases retail customer protections by establishing these obligations under the Exchange Act so that the Commission may enforce them directly and examine for compliance. Additionally, to the extent that market best practices may reflect some FINRA guidance that is not required by FINRA's rules, some broker-dealers may not currently implement these practices. To the extent that broker-dealers and their associated persons do not currently implement existing best practices that will be codified in Regulation

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[1190] *See* FINRA 2018 Letter.

Best Interest, retail customers will benefit because it will increase the implementation of these best practices throughout the industry.

2. Disclosure Obligation

As adopted, the Disclosure Obligation of Regulation Best Interest's requires a broker-dealer, prior to or at the time of the recommendation, to provide to the retail customer, in writing, full and fair disclosure of all material facts relating to the scope and terms of the relationship and all material facts relating to conflicts of interest that are associated with the recommendation. Regulation Best Interest explicitly requires disclosure of "all material facts relating to the scope and terms of the relationship with the retail customer" including: (i) 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; (ii) the material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and (iii) 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 all material facts relating to conflicts of interest that are associated with the recommendation.

Under the baseline, some disclosure obligations already exist, as do an array of market practices with respect to the disclosure of capacity, fees, services, and conflicts of interest.[1191]

[1191] For instance, broker-dealers are subject to a number of disclosure obligations under the Exchange Act when they effect certain customer transactions. These disclosure obligations include written disclosure about capacity, compensation, and third-party

The Disclosure Obligation will enhance disclosure obligations that exist under the baseline and bring greater alignment to market practices by establishing an explicit and broad disclosure requirement under the Exchange Act that applies to all broker-dealers when they make a recommendation to a retail customer. We expect this change to improve the quality and consistency of disclosures and thus (1) reduce the information asymmetry that may exist between a retail customer and her broker-dealer, and (2) facilitate customer comparisons of different broker-dealers which we expect will, in turn, increase competition among broker-dealers, including with respect to fees and costs, as discussed below.[1192]

Relative to the baseline, the Disclosure Obligation will change how broker-dealers disclose information to their retail customers in several specific ways. First, under the baseline, a

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remuneration related to the transaction, and disclosures about whether the broker-dealer has any control, affiliation, or interest in the security or the issuer of the security being offered. Broker-dealers also face liability under the antifraud provisions of the federal securities laws for failure to provide disclosure, such as disclosure of "honest and complete information" or any material adverse facts or materials conflicts of interest, including any economic self-interest, when recommending a security (*see supra* footnote 988). In addition, broker-dealers must comply with a number of SRO disclosure obligations—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). Finally, broker-dealers may also adjust their practices consistent with existing SRO guidance on specific disclosures—such as FINRA Regulatory Notice 13-23, Brokerage and Individual Retirement Account Fees (July 2013) on fee disclosure. *See* Proposing Release at footnotes 175, 176, 177, and 192; *supra* footnotes 303 and 985-988 for a more detailed discussion on existing disclosure practices.

1192 *See supra* footnote 1072 for a discussion of potential information asymmetries between broker-dealers and retail customers.

broker-dealer and its associated persons are not explicitly required to disclose that they are acting in a broker-dealer capacity when making a recommendation. We also clarify above that the use of the terms "adviser" or "advisor" in a name or title by (i) a broker-dealer that is not also registered as an investment adviser, or (ii) a financial professional that is not also a supervised person of an investment adviser would presumptively violate this particular disclosure requirement. Second, Regulation Best Interest requires that any disclosure made by a broker-dealer be "full and fair," meaning that the broker-dealer is required to provide sufficient information to enable a retail investor to make an informed decision with regard to the recommendation, even where this information is about aspects of the relationship between a retail customer and a broker-dealer that may already require disclosure, implicitly or explicitly, under the baseline. We expect the "full and fair" requirement to benefit retail customers in cases where it results in disclosures that are not currently required under broker-dealer antifraud provisions. Finally, Regulation Best Interest requires that broker-dealers provide these disclosures to retail customers in writing at or before the time of a recommendation. However, we are permitting oral disclosures prior to or at the time of a recommendation and written disclosures after a recommendation under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*.[1193] We focus our discussion of both the benefits and costs of the Disclosure Obligation on these changes relative to the baseline.[1194]

[1193] For example, when oral disclosures are used prior to or at the time of a recommendation,

Regulation Best Interest's Disclosure Obligation is different from the Proposing Release's Disclosure Obligation in two ways. First, while the Proposing Release required that a broker-dealer "reasonably disclose" material facts to retail customers, Regulation Best Interest requires that a broker-dealer provide retail customers with "full and fair" disclosure of material facts. As discussed above, this change from the Proposing Release does not have a substantive effect on the expected economic effect of the Disclosure Obligation. Specifically, in both the Proposing Release and Regulation Best Interest, the formulation of the Disclosure Obligation, as described in the release text, required that a broker-dealer provide sufficient information to enable a retail investor to make an informed decision with regard to a recommendation.[1195] Therefore, we do not expect this change to affect our assessment of Regulation Best Interest's costs and benefits. Second, whereas the Proposing Release's Disclosure Obligation did not explicitly require a broker-dealer to disclose particular types of material facts relating to the scope and terms of its relationship with a retail customer, Regulation Best Interest explicitly requires that these material facts include the capacity in which the broker-dealer is acting, fees and costs, and the type and scope of services provided, including material limitations on the

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broker-dealers must maintain a record of the fact that oral disclosure was provided. *See supra* footnotes 301 and 507-508 and surrounding discussion for more detail on when oral disclosure prior to or at the time of a recommendation and disclosure in writing after a recommendation are permitted.

1194 *See supra* footnotes 1157-1159.

1195 *See* Proposing Release at Section II.D.1.c.

securities or investment strategies that may be recommended. We include any economic effects associated with this change in our discussion of Regulation Best Interest's benefits and costs. Finally, while we discuss the direct benefits and costs of the Disclosure Obligation in this section, retail customers, broker-dealers, investment advisers, and their financial professionals may experience indirect benefits or costs due to competitive effects caused by the Disclosure Obligation. We discuss any competitive effects below in Section III.D.1.

a. Benefits

Regulation Best Interest requires that brokers, dealers, or natural persons associated with a broker-dealer disclose that they are acting as a broker, dealer, or an associated person of a broker-dealer prior to or at the time of a recommendation to a retail customer. Broker-dealers are not explicitly required to disclose this information prior to or at the time of a recommendation under the baseline, though they may disclose it to comply with other federal securities laws and SRO rules, or because they consider it to be a market best practice.[1196] This requirement is most likely to have economic effects when retail customers have both brokerage and advisory accounts with the same financial professional, as may be the case if the financial professional is dually-registered. It is designed to make all retail customers aware of the capacity

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[1196] For example, under the baseline, broker-dealers may decide that disclosing the capacity in which it is acting is necessary in order to meet its duty of fair dealing under the antifraud provisions of the federal securities laws. In addition, broker-dealers must disclose whether they effected the transaction as a principal or agent in the customer confirmation statement pursuant to Exchange Act Rule 10b-10, which a retail customer generally receives after the trade is completed.

in which their broker-dealer is acting when a recommendation is made, which may help the retail customer better evaluate the advice they receive. For instance, the cost to the retail customer of acting on such advice will typically depend on whether the advice is tied to the retail customer's brokerage or advisory account. In addition, understanding the capacity in which a financial professional is acting may provide the retail customer with context for, and facilitate review of, other relevant disclosures by the broker-dealer. Knowing that she is receiving advice from a broker-dealer, or an associated person of a broker-dealer, may focus the retail customer's attention on any potential conflicts of interest specifically associated with receiving a recommendation from a broker-dealer. For example, a disclosure that a firm is acting in the capacity of a broker-dealer may encourage a retail customer to seek additional information about commissions, which could give the firm or its financial professional an incentive to recommend transactions that may be inconsistent with the client's most efficient investment strategy, such as a buy-and-hold strategy.

While the capacity disclosure requirement and the disclosures investors will receive in Form CRS will increase the likelihood that retail customers understand the nature of their relationship with a broker-dealer or financial professional, and hence how this relationship might affect the recommendations retail customers receive, some investors may form beliefs about the nature of their relationship with a broker-dealer or financial professional based on their use of particular names and titles such as "adviser" or "advisor," as well as how their services are marketed. In cases where these terms are used by (i) a broker-dealer that is not also registered as an investment adviser, or (ii) a financial professional that is not also a supervised person of an investment adviser, some retail customers may not fully understand that their broker-dealer or financial professional is not acting in the capacity of an investment adviser, even though

investors receive some information about the capacity their broker-dealer or financial professional is acting in on Form CRS or other disclosures.[1197]

To the extent that, despite the disclosures provided on Form CRS, the use of the titles "adviser" and "advisor" causes investor confusion about the nature of the relationship retail investors have, or will have, with a broker-dealer or financial professional, the presumption that the use of these titles by (i) a broker-dealer that is not also registered as an investment adviser, or (ii) a financial professional that is not also a supervised person of an investment adviser would violate the capacity disclosure requirement will potentially benefit investors in two ways.[1198] First, certain investors may seek an advisory relationship and would be better off receiving advice from an investment adviser. In situations where confusion associated with titles might cause such an investor to mistakenly engage in a relationship with a broker-dealer or an associated person of a broker-dealer, the presumption should mitigate costs the investor might incur associated with receiving and, potentially, acting on recommendations from a broker-dealer,

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[1197] Investors may not fully understand this capacity disclosure because, for example, their financial professional is not a supervised person of an investment adviser but works for a dual-registrant, and they interpret Form CRS as suggesting the financial professional also provides both types of services. Alternatively, even if an investor's broker-dealer or financial professional solely offers services in a broker-dealer capacity, the use of the titles "adviser" or "advisor" may leave her confused about the nature of the services provided, despite the capacity disclosure on Form CRS. *See* Relationship Summary Proposal at footnotes 411-412.

[1198] Several commenters generally ascribed benefits to restricting the usage of the terms "adviser" and "advisor." *See supra* footnotes 326-330.

as well as costs associated with correcting this mismatch by switching to an investment adviser.[1199] Second, to the extent that, as a result of the use of the titles "advisor" or "adviser," any confusion might remain about the capacity in which a broker-dealer or its associated person is acting, the presumption should alleviate that confusion and thus increase the likelihood that retail customers focus their attention on any potential conflicts of interest specifically associated with receiving a recommendation from a broker-dealer. Any benefits associated with the presumption will apply for current and potential retail customers of the approximately 100 broker-dealers with retail customers that are not also investment advisers and use the terms "adviser" or "advisor" in their names, and for current and potential retail customers of the approximately 16% of all registered representatives that use these titles and are not dually registered.[1200] These benefits will be limited to the extent that broker-dealers and their financial professionals choose other names or titles that may indicate that they provide advisory services or use marketing materials that hold them out as providing advisory services but do not trigger

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1199 *See* Relationship Summary Proposal at footnote 674 for further discussion of the costs associated with a mismatch between an investor and their preferred type of investment advice provider.

1200 Staff analysis found that 100 retail-facing broker-dealers as of December 2018 use either "adviser" or "advisor" in their firm names. *See* Relationship Summary Proposal at footnote 685 for more discussion of the estimate that approximately 16% of all registered representatives use these titles and are not dually registered.

the presumption or preclude application of the solely incidental prong of the broker-dealer exception to the definition of investment adviser.[1201]

As discussed above, under the baseline, broker-dealers may, in practice, already disclose information about the fees they charge, the type and scope of services they provide, and any conflicts of interest associated with their recommendations.[1202] However, Regulation Best Interest's explicit requirement that broker-dealers disclose all material facts related to the scope and terms of their relationship with a retail customer and all material facts relating to conflicts of interest that are associated with a recommendation may provide retail customers with useful information that they may not currently receive, enabling them to make more informed investment decisions. The magnitude and nature of this benefit will depend on the extent to which a broker-dealer already discloses these material facts and how broker-dealers choose to disclose this information. For example, if broker-dealers choose to disclose all material facts in one consolidated document, the disclosure may, depending on the facts and circumstances of the disclosure, be more informative to some retail customers than disclosures that are provided

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1201 *See supra* footnotes 336-340.

1202 These disclosures may stem from implicit or explicit requirements under federal securities laws. For example, broker-dealers are explicitly required to disclose certain aspects of the fees their retail customers pay, directly and indirectly, under Exchange Act Rule 10b-10 (*see, e.g.*, 913 Study at footnotes 256-259). In other cases, courts have found that broker-dealers may implicitly be required to disclose conflicts of interest or other material facts related to the scope and terms of their relationship with retail customers (*see, e.g.*, 913 Study at footnotes 249-255). *See also* NASD Notice to Members 92-11.

across many documents. In other cases, layered disclosures may allow broker-dealers to target their disclosures to their particular retail customer base at the relevant point in time, increasing the likelihood that investors read these disclosures.[1203]

While the Proposing Release's Disclosure Obligation did not explicitly require a broker-dealer to disclose particular types of material facts relating to the scope and terms of its relationship with a retail customer, Regulation Best Interest explicitly requires that these material facts include: (1) the capacity in which the broker-dealer is acting; (2) fees and costs; and (3) the type and scope of services provided, including material limitations on the securities or investment strategies that may be recommended. We generally anticipate greater benefits under Regulation Best Interest than under the Proposing Release. Specifically, to the extent that broker-dealers may not have disclosed the types of information we are requiring under Regulation Best Interest, Regulation Best Interest should increase the consistency of disclosure practices across broker-dealers, which may make it easier for investors to compare disclosures from and services offered by different broker-dealers or other firms. In addition, if some broker-dealers would not have disclosed the specific types of information required under Regulation Best Interest, and retail customers find that information useful, Regulation Best Interest may facilitate more informed decisions by retail customers when they are deciding whether or not to open an account or use a recommendation. For example, disclosures about the scope and terms

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[1203] *See* the discussion of layered disclosure in *supra* Section II.C.1.c. *See also supra* footnote 540 on the potential benefits of layered disclosure.

of services offered by a broker-dealer or about their fees and costs may facilitate more informed decisions by retail customers as to which type of account is appropriate for them and whether they should open an account with a given broker-dealer. Alternatively, disclosures about conflicts of interest or fees and costs may facilitate more informed decisions by retail customers as to whether or not they should use a recommendation of a securities transaction or investment strategy.

Regulation Best Interest also explicitly requires that disclosures be "full and fair," and thus that a broker-dealer must provide sufficient information to enable a retail customer to make an informed decision with regard to a recommendation.[1204] Broker-dealers may disclose, for example, certain conflicts of interest associated with their recommendations under the baseline. However, under existing federal securities laws and SRO rules, they are not expressly required to provide full and fair disclosure in the manner required under Regulation Best Interest. As a result, existing disclosure practices may not be designed to specifically help retail customers make informed decisions about the recommendations they receive. By explicitly requiring that broker-dealers provide sufficient information to enable retail investors to make an informed decision with regard to a recommendation, Regulation Best Interest imposes a minimum standard on disclosures that may increase the consistency of disclosure practices across broker-dealers relative to the baseline. This may also cause such disclosures to be more useful to retail

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[1204] *See* discussion at *supra* footnotes 463-469.

customers in evaluating the advice they receive, thereby enabling them to make more informed decisions about the recommendations they receive. To the extent that disclosure obligations under the baseline already result in broker-dealers providing sufficient information to enable a retail customer to make an informed decision with regard to a recommendation, the magnitude of the benefits from this component of the Disclosure Obligation is likely to be correspondingly reduced.[1205]

Regulation Best Interest's Disclosure Obligation also establishes a standard for the form and timing of disclosures by requiring that they be made in writing prior to or at the time of a recommendation. While broker-dealers may already disclose information on the fees they charge, the type and scope of services they provide, and any conflicts of interest associated with their recommendations under the baseline, federal securities laws and SRO rules may not explicitly specify the form and timing of such disclosures. In cases where these requirements are explicit, they may not require delivery at or prior to a retail customer's evaluation of the recommendations they receive and any corresponding investment decision. In contrast, while broker-dealers will have some flexibility regarding the form and timing of their disclosures under Regulation Best Interest, retail customers will receive standardized disclosures about the fees and costs, as well as any conflicts of interest, associated with a recommendation prior to or at the time of receiving the recommendation. The Disclosure Obligation should increase the

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[1205] *See supra* footnote 1191 for more on disclosure obligations and requirements under the baseline.

consistency of disclosure practices across broker-dealers and across different types of information relative to the baseline, thereby increasing the likelihood that retail customers have the information they need to make a more informed and efficient investment decision at the time they receive a recommendation.

As noted above, we are permitting oral disclosure prior to or at the time of a recommendation and written disclosure after a recommendation has been made under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*.[1206] Because oral disclosure is permitted in cases where written disclosure prior to or at the time of recommendation is not feasible or practical, investors may benefit by receiving information that otherwise may not have been available to them at the time they make an investment decision. In contrast, because written disclosure is permitted in instances where existing regulations permit disclosure after a recommendation, the benefits associated with the form and timing of disclosures under Regulation Best Interest may be reduced if the information in such disclosures would have been useful to investors in making an investment decision. However, for both oral disclosure prior to or at the time of a recommendation and written disclosure after a recommendation has been made as permitted under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*, retail customers will still receive disclosures in writing prior to a recommendation regarding the circumstances under

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[1206] *See supra* footnote 1193.

which oral disclosure or disclosure after a recommendation will occur and the material facts that will be disclosed under these circumstances.[1207]

Several commenters stated that there are limits to the effectiveness of disclosure and cited a number of studies suggesting that disclosure alone is unlikely to solve the issues surrounding, for example, the conflicts of interest between a broker-dealer or the associated person of a broker-dealer and a retail customer.[1208] Another commenter cited the 2008 RAND Study, concluding that investors do not have the education or background to understand financial disclosures and do not read long, formulaic documents.[1209] Other commenters claimed that numerous academic studies demonstrate that disclosing conflicts of interest does not adequately address the potential harm they cause to investors.[1210] Another commenter provided studies showing that disclosure can encourage better behavior by broker-dealers, improving investor welfare.[1211]

As discussed above, we acknowledge studies showing disclosure can vary in its effectiveness depending on the issue it is intended to address, its intended audience, and the

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1207 *See* discussion following *supra* footnote 301.

1208 *See* Morningstar Letter; EPI Letter; Better Markets August 2018 Letter; St. John's U. Letter; Letter from Tom C.W. Lin, Professor of Law, Temple University Beasley School of Law (Jul. 11, 2018) ("Lin Letter").

1209 *See* Galvin Letter and discussion of 2008 RAND Study.

1210 *See* State Treasurers Letter; Better Markets August 2018 Letter; PIABA Letter.

1211 *See* Morningstar Letter.

format in which it is delivered.[1212] To the extent some retail customers are not able to understand the information disclosed by a broker-dealer regarding the scope of services it provides and the conflicts of interest associated with the recommendations it makes, the benefits of the Disclosure Obligation will not directly affect those investors, and may not increase the efficiency of their investment decisions. However, Regulation Best Interest is not limited to disclosure; rather, the Disclosure Obligation is just one component of Regulation Best Interest that as a whole will enhance the efficiency of recommendations that broker-dealers provide to retail customers, help retail customers evaluate the recommendations received, and improve retail customer protection when receiving recommendations from broker-dealers. In particular, in addition to the Disclosure Obligation, both the Care Obligation and the Conflict of Interest Obligation, discussed below, are designed to promote more efficient investment decisions by imposing affirmative obligations on the broker-dealer that cannot be fulfilled through disclosure alone, regardless of whether the retail customer fully incorporates disclosed information into its investment decisions.

Additionally, to the extent that the information disclosed by broker-dealers as a result of Regulation Best Interest increases the comparability of the securities and services offered by different broker-dealers, it may foster competition between broker-dealers that benefits even those retail customers who are not able to understand the information disclosed by broker-

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[1212] *See supra* Section III.B.4.c.

dealers.[1213] For example, if an increase in comparability promotes competition on the basis of recommendation quality, it may cause broker-dealers to mitigate or eliminate conflicts even in cases where the Conflict of Interest Obligation does not expressly require policies and procedures to mitigate or eliminate such conflicts. Because the Disclosure Obligation provides broker-dealers with some flexibility as to the form and timing of their disclosures, the magnitude of this benefit will depend on the extent to which these disclosures are comparable across broker-dealers or to which the disclosures made by one broker-dealer draw attention to practices at other broker-dealers that may not be in the best interest of retail customers.

The magnitude of the Disclosure Obligation's benefits will depend on a number of factors, including which facts about the scope and terms of their relationship with retail customers are material, the extent to which broker-dealers already disclose information in a manner that is consistent with the Disclosure Obligation under the baseline, the manner in which they choose to disclose this information, the extent to which retail customers understand such disclosures and would use them in making investment decisions, and the extent to which such disclosures would improve the efficiency of retail customers' investment decisions, which varies with the specific circumstances of each retail customer.

[1213] *See* Relationship Summary Adopting Release at footnote 1035 for similar discussion of the potential benefits comparability can have on competition.

b. Costs

We expect broker-dealers and their financial professionals to incur costs as a result of Regulation Best Interest's Disclosure Obligation, and retail customers may incur indirect costs as well. In this section, we analyze these costs in terms of how Regulation Best Interest changes disclosure requirements for broker-dealers relative to the baseline.

The requirement that broker-dealers or their associated persons disclose the capacity in which they or their associated persons are acting prior to or at the time of making a recommendation may be fulfilled by delivering the Relationship Summary, depending on the facts and circumstances.[1214] For example, a standalone broker-dealer may satisfy this requirement of the Disclosure Obligation by delivering the Relationship Summary to the retail customer, as required pursuant to Form CRS. In contrast, for broker-dealers who are dually registered, and associated persons who are either dually registered or who are not dually registered but only offer broker-dealer services through a firm that is dually registered, delivering the Relationship Summary will not be sufficient to disclose the capacity in which they are acting. Thus, while standalone broker-dealers that deliver the Relationship Summary generally will not incur additional costs to comply with this requirement of the Disclosure Obligation, dual-registrants will incur additional costs, which could include the creation of disclosure materials as well as policies and procedures to assist their associated persons in determining when they are

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[1214] *See supra* footnotes 320-321 and surrounding discussion.

acting in a broker-dealer capacity. However, dual-registrants and their associated persons will have some flexibility with respect to the form, timing, or method of satisfying this requirement of the Disclosure Obligation when they or their associated persons make recommendations acting as brokers, dealers, or associated persons of a broker or dealer.[1215]

The presumption that the use of the titles "adviser" and "advisor" would violate the capacity disclosure requirement may impose costs on certain broker-dealers and their financial professionals, investors, and other affected parties. Broker-dealers and their associated persons currently using names and titles containing the terms "adviser" and "advisor" will incur direct costs, including those associated with changing firm names, written and/or electronic marketing materials, advertisements, and personal communication tools that use these titles, among other items, as well as any costs associated with voluntary outreach to customers to inform them of these changes.[1216] While commenters did not provide specific estimates of these costs, they

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1215 *See supra* footnote 306.

1216 *See e.g.*, HD Vest Letter (stating that "[t]he term 'Advisor' permeates nearly every HD Vest disclosure, representative agreement, selling agreement, client agreement, client communication, marketing piece, and website" and noting that broker-dealers would need to develop compliance policies to ensure oversight of the names and titles used by their financial professionals); LPL August 2018 Letter (stating that "legal entities with so-called 'doing business as' (d/b/a) names containing the term 'advisor' or 'adviser'—through which many securities professionals operate their business practices—will be required to rename their businesses and incur significant costs and disruption in updating all marketing materials with the prior name."); SIFMA August 2018 Letter; Morgan Stanley Letter.

described them as "very real costs,"[1217] "significant costs and disruption,"[1218] and "burdensome and costly."[1219] To the extent that a broker-dealer's company name that includes "adviser" or "advisor" is recognized as a brand in the market and therefore represents a valuable intangible asset to the broker-dealer, the broker-dealer may also incur indirect costs if some of its "brand value" is lost following a company name change.[1220] Additionally to the extent that investors who have a preference for receiving advice from a broker-dealer or an associated person of a broker-dealer search exclusively for such advice using the terms "adviser" or "advisor," they may experience a reduction in the choice of service providers available to them (e.g., they might only find dual-registrants).[1221] Finally, organizations that award credentials or certifications to broker-dealers and financial professionals that include the terms "adviser" or "advisor" may lose revenues associated with a reduction in future demand for these credentials and certifications, or

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1217 *See* HD Vest Letter.

1218 *See* LPL August 2018 Letter. *See also* NAIFA Letter (noting the "significant costs to update all materials, marketing, signage, legally-required disclosure documents, etc.…"); SIFMA August 2018 Letter (noting the "significant costs and burdens" that would be involved with "[e]xtensive repapering.").

1219 *See* Morgan Stanley Letter.

1220 Academic evidence suggest corporate brands are valuable intangible assets to firms. *See, e.g.*, Mary E. Barth et al., *Brand Values and Capital Market Valuation*, 3 REV. ACCT. STUD. 41 (1998).

1221 The extent of this potential cost depends on how likely it is that investors rely on the titles "adviser" and "advisor" in finding a broker-dealer. For example, one survey suggests that 40-50% of investors find their financial professionals through personal recommendations, not via searches for these titles (*see supra* footnote 946 and discussion in Relationship Summary Adopting Release at Section IV.B.2.a).

lose revenues associated with the maintenance of current credentials or certifications by awardees.[1222] Relatedly, affected financial professionals may experience a loss associated with any value they currently derive from the use of these credentials or certifications.[1223] Rather than incur any of the costs associated with changing names and titles discussed above, some broker-dealers may choose to register as investment advisers if they determine it will be less costly, in which case these broker-dealers will incur any costs associated with dual registration. The potential costs associated with the presumption apply for the approximately 100 broker-dealers, as of December 2018, with retail customers that are not also investment advisers and use either "adviser" or "advisor" in their firm names, and for the approximately 16% of all registered representatives that use these titles and might be affected by the presumption.[1224]

The requirement that broker-dealers disclose material facts relating to the material fees and costs that apply to a retail customer's transactions, holdings, and accounts may also be partially fulfilled by delivering the Relationship Summary. Form CRS will require broker-dealers to provide retail investors a high-level summary of principal fees and costs, including transaction-based fees, as well as a narrative discussion of other fees that retail investors will pay

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1222 *See* IWI Letter (noting that "Title Restrictions, as proposed, have a potential to impact the long-term growth of two of the Institute's registered marks."). This commenter did not provide specific data or estimates on the potential magnitude of this effect.

1223 *See* NAIFA Letter. This commenter did not provide specific data or estimates on the potential magnitude of this effect.

1224 *See supra* footnote 1200.

directly or indirectly. However, while providing such high-level summaries partially complies with the Disclosure Obligation, the Relationship Summary is unlikely to provide retail customers with all of the material facts about the fees and costs that apply to a particular recommendation.[1225] As a result, Regulation Best Interest will impose costs on broker-dealers associated with assessing whether facts about the fees and costs that apply to a retail customer's transactions, holdings, and accounts are material and delivering those material facts to retail customers.

Broker-dealers will have some flexibility in how they comply with this requirement, which will allow them to tailor these disclosures to the needs of their retail customers and to implement them in a manner that is as cost efficient as possible, given their business models. In addition, the Disclosure Obligation may be satisfied by providing documents that broker-dealers are already required to produce or voluntarily produce under the baseline, such as prospectuses, in which case they may only incur costs associated with determining the timing and method by which they deliver these disclosures.[1226] For example, under the baseline, broker-dealers may currently deliver prospectuses to retail customers after the completion of a transaction under the baseline, but would need to deliver them prior to or at the time of a recommendation under Regulation Best Interest, unless made under the circumstances outlined in Section II.C.1, *Oral*

[1225] *See* the discussion following *supra* footnote 368.

[1226] *See* discussion at *supra* footnotes 495-496.

Disclosure or Disclosure After a Recommendation, allowing them to rely on delivery of information after the fact. In cases where required disclosures are already produced under the baseline, broker-dealers and their associated persons may still incur costs associated with delivering these disclosures prior to or at the time of a recommendation if they are not delivered by that time under the baseline.

Broker-dealers may also incur costs as a result of Regulation Best Interest's requirement that they disclose material facts about the type and scope of services provided to a retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer. As discussed above, some broker-dealers may be able to fulfill their obligation to disclose these material facts, such as those related to account monitoring, account minimums, or material limitations on the securities or investment strategies that may be recommended, by complying with Form CRS or by using disclosures included in account opening agreements or other customer disclosures.[1227] For these broker-dealers, this requirement of the Disclosure Obligation should not cause them to incur additional costs beyond an initial assessment of whether they can comply with the Disclosure Obligation using Form CRS or pre-existing disclosures. In cases where a broker-dealer is not able to disclose all material facts relating to the type and scope of services they provide by complying with Form CRS or in combination with existing disclosures, broker-dealers will incur

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[1227] *See supra* footnote 1203.

costs associated with assessing which facts about the type and scope of services provided to retail customers are material and delivering written disclosure of those material facts to retail customers. As discussed above, broker-dealers will have some flexibility in how they comply with this requirement, allowing them to tailor these disclosures to the needs of their retail customers and to their business models and to implement these disclosures in a cost efficient manner.

While the Proposing Release's Disclosure Obligation did not explicitly require broker-dealers or their associated persons to disclose particular types of material facts relating to the scope and terms of their relationship with a retail customer, Regulation Best Interest explicitly requires that these material facts include the capacity in which the broker-dealer or its associated person is acting; material fees and costs; the type and scope of services provided, including material limitations on the securities or investment strategies that may be recommended; and all material facts relating to conflicts of interest that are associated with a recommendation. To the extent that broker-dealers are not disclosing this information or are not disclosing it by the time of a recommendation, broker-dealers may incur higher costs associated with disclosing these material facts under Regulation Best Interest compared to the baseline.

In general, for any material facts relating to the scope and terms of its relationship with retail customers, a broker-dealer may have to determine how to disclose those facts in a manner that is "full and fair," as required by Regulation Best Interest, which will cause it to incur costs. Similarly, the requirement that broker-dealers disclose all material facts in writing prior to or at the time of a recommendation may also impose costs on broker-dealers. For example, even if a broker-dealer currently discloses some information about its fees under the baseline, it may not currently disclose that information prior to the time of a recommendation, and may incur costs

updating systems and processes to ensure the information is disclosed in a manner that complies with Regulation Best Interest's requirements, including any costs associated with delivery of the information to retail customers.

Broker-dealers may incur costs associated with the full and fair disclosure of all material facts relating to conflicts of interest that are associated with a recommendation. As discussed below in our analysis of the Conflict of Interest Obligation, broker-dealers currently have obligations to disclose certain material conflicts of interest under the baseline.[1228] To the extent that broker-dealers will be required to disclose material facts about conflicts of interest that they do not currently disclose to retail customers under the baseline, broker-dealers will incur costs associated with assessing whether facts about these conflicts are material and delivering those facts to retail customers. They also may incur costs associated with identifying particular conflicts of interest to disclose.[1229]

As discussed above, there are circumstances where broker-dealers and their associated persons may make oral disclosures or written disclosures after the time of a recommendation under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*. Where oral disclosures are made, broker-dealers and their associated persons may incur costs associated with subsequently documenting such disclosures. These costs may

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[1228] *See infra* footnote 1261. *See also supra* footnotes 985-988.

[1229] *See infra* Section III.C.4 for a discussion of costs associated with identifying conflicts of interest as part of the Conflict of Interest Obligation.

include the time spent documenting such disclosures, the development of systems and processes necessary to document such disclosures, training associated persons to use these systems and processes, and supervising the compliance by associated persons with this obligation. For both oral disclosures and written disclosures made after a recommendation, broker-dealers and their associated persons may incur costs associated with developing initial disclosures about the material facts subject to oral disclosures and written disclosures after a recommendation, the circumstances under which such disclosures will be made, as well as costs associated with training financial professionals to make such disclosures in a manner that complies with Regulation Best Interest.

While most of the costs associated with preparing and delivering disclosures are likely to be incurred by broker-dealers, their associated persons may incur costs as well. For example, when a financial professional is aware that the broker-dealer's disclosure is insufficient to describe "all material facts," the associated person must supplement that disclosure, and may incur costs in developing such disclosure on their own to ensure they are in compliance with the Disclosure Obligation.[1230] The magnitude of this cost will depend on the extent to which the financial professional cannot rely on the disclosure made by the broker-dealer.

[1230] *See* discussion following *supra* footnote 307 for an example of a case where an associated person of a broker-dealer may be required to provide her own disclosures in order to comply with the Disclosure Obligation.

As discussed above, while we are unable to quantify the full costs of Regulation Best Interest, including the Disclosure Obligation, we are able to estimate some of the costs associated with the Disclosure Obligation, specifically the costs related to information collection requirements as defined by the Paperwork Reduction Act. As discussed further below in Section IV.B.1, the Commission estimates that the preparation and delivery of standardized language, fee schedules, and standardized conflict disclosures that broker-dealers are required to provide to retail customers to comply with the Disclosure Obligation will impose on broker-dealers an initial aggregate burden of 6,216,125 hours and an additional initial aggregate cost of $42.84 million as well as an ongoing aggregate burden of 2,101,493 hours.[1231] Thus, the Disclosure

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[1231] The estimate of the initial aggregate burden is based on the following calculation: 5,630 hours + 7,560 hours + 40,200 hours + 2,040,000 hours + 3,780 hours + 20,100 hours + 2,040,000 hours + 3,780 hours + 15,075 hours + 2,040,000 hours = 6,216,125 hours. As discussed in more detail in *infra* Section IV.B.1, 5,630, 7,560, and 40,200 hours are estimates of the initial aggregate burden for the preparation of disclosure of capacity, type, and scope, for dual-registrants and small and large broker-dealers, respectively. 2,040,000 hours is the estimate of the initial aggregate burden for the delivery of the disclosure of capacity, type, and scope to retail customers. 3,780 and 20,100 hours are estimates of the initial aggregate burden for the preparation of disclosure of fees for small and large broker-dealers, respectively. 2,040,000 hours is the estimate of the initial aggregate burden for the delivery of the disclosure of fees to retail customers. 3,780 and 15,075 hours are estimates of the initial aggregate burden for the preparation of disclosure of material conflicts of interest for small and large broker-dealers, respectively. 2,040,000 hours is the 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: $2.80 million + $3.80 million + $15.00 million + $1.88 million + $9.99 million + $1.88 million + $7.49 million = $42.84 million. As discussed in more detail in *supra* Section V.D, $2.80 million, $3.80 million, and $15.00 million are estimates of the initial aggregate cost for the preparation

Obligation will impose an estimated initial aggregate cost of at least $1,508.88 million and an ongoing aggregate annual cost of at least $499.59 million on broker-dealers.[1232] We note that these estimates assume broker-dealers are not currently producing and delivering documents

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of disclosure of capacity, type, and scope, for dual-registrants and small and large broker-dealers, respectively. $1.88 million and $9.99 million are estimates of the initial aggregate cost for the preparation of disclosure of fees for small and large broker-dealers, respectively. $1.88 million and $7.49 million are 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: 3,941 hours + 3,024 hours + 40,200 hours + 408,000 hours + 1,512 hours + 8,040 hours + 816,000 hours + 756 hours + 4,020 hours + 816,000 hours = 2,101,493 hours. As discussed in more detail in *supra* Section V.D, 3,941, 3,024, and 40,200 hours are estimates of the ongoing aggregate burden for the preparation of disclosure of capacity, type, and scope, for dual-registrants and small and large broker-dealers, respectively. 408,000 hours is the estimate of the ongoing aggregate burden for the delivery of the disclosure of capacity, type, and scope to retail customers. 1,512 and 8,040 hours are estimates of the ongoing aggregate burden for the preparation of disclosure of fees for small and large broker-dealers, respectively. 816,000 hours is the estimate of the ongoing aggregate burden for the delivery of the disclosure of fees to retail customers. 756 and 4,020 hours are estimates of the ongoing aggregate burden for the preparation of disclosure of material conflicts of interest for small and large broker-dealers, respectively. 816,000 hours is the estimate of the ongoing aggregate burden for the delivery of the disclosure of material conflicts of interest to retail customers.

[1232] These estimates are calculated as follows: (96,125 hours of in-house legal counsel) x ($415.72/hour for in-house counsel) + (6,120,000 hours for delivery for each customer account) x ($233.02/hour for registered representative) + (90,763 hours for outside legal counsel) x ($497/hour for outside legal counsel) = $1,508.88 million, and (35,056 hours of in-house legal counsel) x ($415.72/hour for in-house counsel) + (2,040,000 hours for delivery for each customer account) x ($233.02/hour for registered representative) + (26,437 hours for in-house compliance counsel) x ($365.39/hour for outside legal counsel) = $499.59 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 *supra* Section V.D.

associated with the Disclosure Obligation. To the extent that broker-dealers are already doing so, these estimates may overstate the costs associated with the information collection requirements as defined by the Paperwork Reduction Act.

Several commenters stated that we underestimated the compliance costs of Regulation Best Interest in the Proposing Release, particularly with respect to the potential transaction-based nature of the Disclosure Obligation and the resultant record-making and recordkeeping requirements.[1233] One commenter stated that if the Disclosure Obligation is a transaction-based requirement, its costs were significantly underestimated in the Proposing Release, citing an estimate that an earlier proposal of a point-of-sale disclosure requirement would cost between $1 million and $1.2 million per firm.[1234] We first note that, given that there are approximately 2,766 broker-dealers with retail-facing operations, the commenter's cited estimate implies initial costs of approximately $1.4 billion and ongoing costs of approximately $1.4 billion,[1235] so the commenter's implied estimate of $1.4 billion in initial costs associated with the Disclosure

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1233 *See* Schwab Letter; ICI Letter; Angel Letter; Vanguard Letter; LPL August 2018 Letter; NSCP Letter.

1234 *See* Schwab Letter, citing April 12, 2004 comment letter from George Kramer of the Securities Industry Association ("SIA"). This estimate is based on a point-of-sale disclosure requirement in proposed rule 15c2-3, for which SIA estimated that implementation costs would be in the order of $500,000 per firm, as would annual costs associated with maintaining and updated necessary systems and procedures. *See also* SIFMA August 2018 Letter at footnote 38 referencing the same estimate.

1235 These estimates are calculated as follows: (2766 retail-facing broker-dealers) x ($500,000 per firm in initial costs) = $1.383 billion. Implied ongoing costs are calculated the same way.

Obligation is consistent with our estimate of initial costs above.[1236] Second, we note that, as discussed in more detail above in Section II.C.1.d, the Disclosure Obligation only requires that certain disclosures be made prior to or at the time of a recommendation, and broker-dealers may use standardized disclosures at an earlier point than the time of a recommendation to the extent such disclosures satisfy the Disclosure Obligation. In this regard, while the commenter's estimate may be indicative for some firms, the cost per firm will vary widely depending on the scope and business model of each broker-dealer. Because Regulation Best Interest provides broker-dealers with some flexibility regarding both the form and timing of the Disclosure Obligation, its costs are likely to be lower than a pure point-of-sale requirement.[1237]

Beyond the estimates provided above for that are derived from estimates developed for purposes of the Paperwork Reduction Act in Section IV.B.1, the Commission is unable to fully quantify the costs of the Disclosure Obligation because the magnitude of these costs depend on firm-specific factors that are inherently difficult to quantify given the principles-based nature of Regulation Best Interest.[1238] These factors include the extent to which current disclosure practices under the baseline are different from the requirements of the Disclosure Obligation, the manner in which broker-dealers choose to comply with the Disclosure Obligation given the

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1236 *See supra* footnote 1232.

1237 *See supra* footnotes 531-533 for a discussion of layered disclosure and footnotes 541-542 for a discussion of the Disclosure Obligation's requirements with respect to timing of disclosures.

1238 *See supra* Section III.C.1.

flexibility it provides, how broker-dealers assess whether facts relating to the scope and terms of their relationship with a retail customer are material, how they determine whether their disclosure of such material facts is full and fair, or the extent to which they will satisfy the Disclosure Obligation's requirements by delivering the Relationship Summary or pre-existing documents.

3. Care Obligation

Under the baseline, broker-dealers are subject to suitability obligations and requirements under the anti-fraud provisions of the federal securities laws and the Suitability Rule when making recommendations to retail customers. The Care Obligation incorporates and adds to existing suitability requirements applicable to broker-dealers, thereby reducing the incidence of inefficient recommendations to retail customers.

FINRA rules require broker-dealers making recommendations to have, based on a particular customer's investment profile, a reasonable basis to believe that the recommendation is suitable for that customer. In addition, FINRA guidance and Commission opinions interpret suitability as prohibiting a broker-dealer from placing its interests ahead of the customer's interest and requiring the recommendations to be consistent with the customer's best interest.[1239] However, this obligation is not explicitly required by FINRA's rule (or its supplementary material). Under the baseline, a recommendation by a broker-dealer or its associated persons

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[1239] *See supra* footnote 570 and 913 Study at footnote 270.

may be consistent with a retail customer's best interest but broker-dealers and their associated persons are not required to make recommendations in the best interest of these customers, as will be required under Regulation Best Interest. Relative to the baseline, the Care Obligation will change how broker-dealers and their associated persons make recommendations to retail customers in several ways, some of which differ from the Proposing Release.

First, the Care Obligation explicitly includes cost as a factor for consideration when determining whether a recommendation is in a retail customer's best interest. In contrast, the Proposing Release emphasized cost as an important factor to consider and stated that broker-dealers may be required to consider cost as a factor when making recommendations, but did not explicitly require its consideration when making a recommendation.[1240] In addition, we clarify above in Section II.C.2 that, when determining whether a recommendation is in a retail customer's best interest with respect to cost or other relevant factors, broker-dealers and their associated persons should consider reasonably available alternatives. Conversely, under FINRA suitability obligations, broker-dealers and their associated persons are not required to consider reasonably available alternatives when determining whether a recommendation is suitable for a retail customer.[1241]

1240 *See supra* footnote 572 and preceding text.

1241 *See id.*

Second, under the baseline, FINRA rules require that 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 contrast, the Care Obligation requires that a broker-dealer or its associated person has a reasonable basis to believe that a series of recommended transactions is not excessive and is in that retail customer's best interest. This is the case at all times—when the broker-dealer or associated person has actual or *de facto* control over a customer's account as well as when no control exists (whether actual or de facto).

Finally, FINRA's suitability standard applies to recommendations of rollover decisions that involve securities transactions, but not necessarily in the absence of a securities transaction.[1242] In addition, FINRA's suitability standard does not explicitly apply to recommendations of account types and implicit hold recommendations resulting from agreed upon account monitoring.[1243] In contrast, Regulation Best Interest explicitly applies to account recommendations as an "investment strategy involving securities," including recommendations of securities account types, as well as rollovers or transfers of assets from one account to another. In addition, under Regulation Best Interest, implicit hold recommendations resulting from agreed

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1242 *See* FINRA Regulatory Notice 13-45 and *supra* footnote 172.

1243 *See supra* footnote 170.

upon account monitoring constitute recommendations of "any securities transaction or investment strategy involving securities," and are therefore within the scope of Regulation Best Interest. Moreover, recommendations to open an IRA or to roll over assets into an IRA are subject to Regulation Best Interest, including the Care Obligation, thereby requiring a broker-dealer or its associated persons to have a reasonable basis to believe that the IRA or IRA rollover is in the best interest of the retail customer at the time of the recommendation, taking into consideration the retail customer's investment profile and other relevant factors, as well as the potential risks, rewards, and costs of the IRA or IRA rollover compared to the retail customer's existing 401(k) or other retirement account. We focus our discussion of both the benefits and costs of the Care Obligation under Regulation Best Interest on these changes relative to the baseline.

Regulation Best Interest's Care Obligation differs from the Proposing Release's Care Obligation in two ways that respond to commenter concerns but that we do not expect to have significant economic effects.[1244] First, the general best interest standard of conduct from the Proposing Release is incorporated into Regulation Best Interest's Care Obligation, which, as adopted, also requires that a broker-dealer or its associated persons have a reasonable basis to believe that a recommendation, or series of recommendations, does not place the financial or other interest of the broker-dealer or its associated persons ahead of the interest of the particular

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[1244] *See* discussion at *supra* footnotes 147, 606, and 577-584.

retail customer. Broker-dealers and their associated persons can comply with Regulation Best Interest as a whole by complying with its four component obligations, which now explicitly include the Proposing Release's general best interest standard in elements of the Care Obligation. This change to the Care Obligation, as compared to the Proposing Release, is intended to emphasize the importance of determining that each recommendation is in the best interest of the retail customer and that it does not place the broker-dealer's interests ahead of the retail customer's interest; however, we do not believe there will be significant economic effects associated with this change from the Proposing Release.[1245] Second, Regulation Best Interest, as adopted, does not explicitly require broker-dealers or their associated persons to exercise "prudence" in making recommendations. Instead they must exercise reasonable diligence, care, and skill in making such recommendations. While we removed the term "prudence" to address commenter concerns that it might create legal confusion and uncertainty, this does not change the requirements or obligations under the Care Obligation as compared to the Proposing Release.[1246] Therefore, we do not expect this change to have a significant economic effect, as compared to the Proposing Release.

[1245] If anything, to the extent that broker-dealers or their associated persons might have misunderstood the Proposing Release with respect to their obligation to provide recommendations that are in the best interest of retail customers, Regulation Best Interest, as adopted, emphasizes the importance of determining that each recommendation is in the best interest of the retail customer will benefit retail customers.

[1246] *See supra* footnotes 579-585 and surrounding discussion.

a. Benefits

As described in the Proposing Release, the Care Obligation did not explicitly require broker-dealers and their associated persons to consider the costs associated with a recommendation when determining whether it was in a retail customer's best interest, though the Proposing Release discussed cost as a relevant factor in making this determination, and noted that broker-dealers might be required to consider cost as a factor when making recommendations under the baseline.[1247] The Care Obligation under Regulation Best Interest includes an explicit requirement to consider the cost of a recommendation. If this causes broker-dealers and their associated persons to more carefully consider cost in relation to other factors, compared to the baseline, it should reduce the incidence of recommendations of higher cost investments from a set of reasonably available alternatives that achieve the retail customer's objective. If the explicit requirement to consider the cost of a recommendation encourages broker-dealers and their associated persons to more carefully consider cost, compared to the baseline, the final rule makes it less likely that a broker-dealer or its associated persons could have a reasonable basis to believe such investments are in the retail customer's best interest because it would be difficult to have such a belief for investments that are identical beyond their costs. Therefore, including cost

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[1247] *See supra* footnote 572.

as a required factor in Regulation Best Interest should enhance the efficiency of recommendations to retail customers relative to the baseline.[1248]

As discussed above, while a "quantitative suitability" requirement applies to series of recommended transactions under the baseline, it only applies in cases where a broker-dealer has "control" over a customer account. Relative to the baseline, broker-dealers and their associated persons will be required to have a reasonable basis to believe that *any* series of recommended transactions is in the retail customer's best interest, not just series of recommended transactions that occur in an account they control. This change relative to the baseline should enhance investor protection by reducing the incidence of cases where a broker-dealer or its associated persons recommend an excessively high rate of portfolio turnover, or "churn," for accounts that they do not control. In addition, the discussion above regarding the potential benefits from the increased standard of conduct required by the Care Obligation in the context of individual recommendations also applies to series of recommended transactions. Enhancing the standard of conduct that applies to series of recommended transactions and reducing the incidence of recommendations that result in excess portfolio turnover should result in more efficient recommendations, benefiting retail customers. We are unable to specifically quantify these potential benefits because, in addition to the reasons cited above, we do not have and cannot reasonably obtain comprehensive data on how often broker-dealers, for accounts they do not

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[1248] *See* discussion surrounding *supra* footnotes 563-565.

control, recommend series of transactions that result in excessive portfolio turnover and are therefore not in the best interest of their retail customers.

Regulation Best Interest applies to account recommendations, including recommendations to open an IRA or to participate in an IRA rollover. Accordingly, these types of recommendations are subject to the Care Obligation (as well as the other components of Regulation Best Interest). Several commenters highlighted the heightened risk of harm associated with IRA and IRA rollover recommendations because the amount of assets associated with such recommendations can be a significant portion of a retail customer's net worth, and one commenter cited academic and industry studies that identify activities that are particularly prone to conflicts of interest, including IRA rollovers.[1249] We acknowledge the heightened effect that recommendations to open an IRA or to participate in an IRA rollover can have on the financial well-being of retail customers.[1250] While FINRA's suitability standard under the baseline applies to rollover recommendations involving securities transactions, the suitability standard does not necessarily apply to a rollover recommendation if that recommendation does not involve a securities transaction.[1251] To the extent that broker-dealers and their associated persons currently make recommendations to open an IRA or to participate in an IRA rollover that do not

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1249 *See* CFA August 2018 Letter; AARP August 2018 Letter; Morningstar Letter; CFA Institute Letter.

1250 *See supra* footnotes 191-192. *See also* Fiduciary Benchmarks Letter.

1251 *See supra* footnote 1242.

involve securities transactions under the baseline, Regulation Best Interest should result in IRA and IRA rollover recommendations to retail customers that are more efficient because they will be in the retail customer's best interest regardless of whether or not they involve securities transactions.

Regulation Best Interest also applies to other account type recommendations. Broker-dealers may offer different types of brokerage accounts that include different levels of services and costs. The choice of account type can have a significant effect on the financial wellbeing of a retail customer. For example, a recommendation to open an advisory over a brokerage account, or vice versa, can have a substantial long-term effect on a retail customer's assets. This effect may depend on the costs the retail customer incurs through the particular account as well as the retail customer's investment profile.[1252] Regulation Best Interest should result in recommendations regarding account type that are in the best interest of the retail customer, particularly with respect to cost, increasing the efficiency of the account type recommendations retail customers receive relative to the baseline.

Finally, by clarifying that implicit hold recommendations resulting from agreed-upon account monitoring services constitute recommendations of "any securities transaction or investment strategy involving securities," the Care Obligation will apply at the point in time at which their broker-dealer or associated person performs the agreed-upon monitoring, regardless

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[1252] *See supra* footnote 191.

of whether the broker-dealer or an associated person communicates any recommendation. This should increase the efficiency of the implicit hold recommendations retail customers receive relative to the baseline.

b. Costs

We expect broker-dealers and their associated persons to incur costs as a result of the Care Obligation, and, to the extent broker-dealers pass these costs on to retail customers, these customers may incur costs as well. In this section, we analyze these costs in terms of how Regulation Best Interest, as adopted, changes the required standard of care broker-dealers owe their retail customers relative to the baseline. We also highlight any changes in our assessment of these costs as compared to the Proposing Release. We discuss the costs of complying with the Care Obligation, such as those associated with training employees or developing policies and procedures, in Section III.C.5.

To comply with the Care Obligation, some broker-dealers may stop offering certain securities to retail customers, or their associated persons may stop recommending certain securities to retail customers. These decisions may be based on determinations that offering or recommending those securities typically would not satisfy the Care Obligation. To the extent that they earn revenue from offering and recommending such securities, broker-dealers and their associated persons may incur costs associated with the determination to cease offering or recommending these products.

Commenters stated that our analysis should not consider lost revenue as a cost of complying with Regulation Best Interest, except to the extent that the lost revenue is passed on to investors in the form of higher fees, because these types of costs are a direct result of policies that make investors better off.[1253] As discussed above, our economic analysis must consider the costs Regulation Best Interest may impose on all affected parties, including broker-dealers. However, we believe that any loss of revenues associated with recommendations that would not satisfy the Care Obligation is compensated by the corresponding benefit to retail customers—namely the provision of more efficient recommendations by their financial professionals.[1254] In addition, even if broker-dealers or their associated persons have a reasonable basis to believe that a certain investment could be in the best interest of some retail customers, they may forgo offering or recommending the investment if, for example, they think that it may increase their exposure to regulatory enforcement risk over their compliance with Regulation Best Interest.[1255] This could result in costs to both the broker-dealer and any retail customers for whom the investment would be an efficient investment choice.

Because the Care Obligation holds broker-dealers and their associated persons to an enhanced standard of conduct, they may incur costs associated with increased legal exposure if, for example, Regulation Best Interest results in increased retail customer arbitrations or litigation.

1253 *See supra* footnote 1164.

1254 *See supra* Section III.A.2 for a more detailed discussion of efficient recommendations.

1255 *See, e.g.*, Iowa Insurance Commissioner Letter.

For example, one commenter stated that the lack of clarity in how to weight various factors associated with the potential risks and rewards of a recommendation could lead to arbitrary claims regarding other alternative recommendations that, *ex-post*, would have performed better.[1256] Similarly, because the Care Obligation also requires that a series of recommended transactions be in the best interest of a retail customer, regardless of whether a broker-dealer or an associated person controls the retail customer's account, a broker-dealer could incur the same types of costs associated with increased arbitration or litigation risk relative to the baseline. We cannot anticipate the extent to which Regulation Best Interest will increase retail customer claims, but many retail customer arbitrations are already predicated in whole or in part on facts alleging that a broker-dealer breached a fiduciary duty or its suitability obligations. Additionally, the clarity in the rule text and this release regarding the Care Obligation, as well as the other aspects of Regulation Best Interest that bring enhanced conduct and clarity (e.g., the policies and procedures requirement and that Regulation Best Interest applies only at the time a recommendation is made) should mitigate against an increase in the likelihood and cost of such claims.

The Care Obligation explicitly requires that cost be considered as a factor when determining whether a recommendation is in the best interest of a retail customer. Several commenters stated that the Proposing Release's guidance emphasizing cost as a specific factor in

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1256 *See* CCMC Letters.

the Care Obligation could create uncertainty around how the cost of a recommendation should be weighed with other factors.[1257] As discussed above, the inclusion of cost as a factor in the Care Obligation does not require that the "least expensive" recommendation be made by a broker-dealer or its associated person; cost is one factor, but not the only relevant factor. Nonetheless, to the extent that the inclusion of cost as a factor in the Care Obligation increases the arbitration or litigation risk to which broker-dealers or their associated persons are exposed, this change could impose additional costs on broker-dealers.

Regulation Best Interest also expressly applies to account recommendations, including recommendations of securities account types, as well as rollovers or transfers of assets from one account to another. We also clarify above that implicit hold recommendations resulting from agreed-upon account monitoring are within the scope of Regulation Best Interest and are therefore subject to the Care Obligation. Should they choose to discontinue offering certain services, as a result of Regulation Best Interest, broker-dealers could lose revenue associated with making recommendations for account types (including IRAs). They may also decide to cease offering monitoring services on retail customer accounts. However, as we discussed above with respect to recommendations more generally, we believe that any loss of revenues associated with recommendations that would not satisfy the Care Obligation is compensated by the

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1257 *See* ICI Letter; CCMC Letters; LPL August 2018 Letter.

corresponding benefits to retail customers associated with more efficient account recommendations.

The Commission is unable to fully quantify the costs that the Care Obligation will impose on broker-dealers, their associated persons, or their retail customers because the magnitude of these costs depends on firm-specific factors that are inherently difficult to quantify given the principles-based nature of Regulation Best Interest.[1258] These factors include the extent to which broker-dealers and their associated persons currently engage in practices under the baseline that would satisfy the Care Obligation, either of their own volition or as a result of complying with other regulations; the extent to which broker-dealers and their associated persons will cease recommending certain securities or investment strategies; the likelihood that retail customers file more arbitration or litigation claims; and the extent to which broker-dealers pass on any cost increases to their retail customers.[1259]

4. Conflict of Interest Obligation

The Conflict of Interest Obligation under Regulation Best Interest is intended to reduce the agency costs that arise when a broker-dealer and its associated persons provide a recommendation to a retail customer by addressing the effect of the associated person's or broker-dealer's conflicts of interest on the recommendation.

[1258] *See also supra* Section III.C.1.a.

[1259] *See* discussion following *infra* footnote 1330 for discussion of factors affecting whether broker-dealers pass on costs to their retail customers and the resultant competitive effects.

The Conflict of Interest Obligation would require that broker-dealers establish, maintain, and enforce written policies and procedures that are reasonably designed to address the effect of the broker-dealer's and the associated persons' conflicts of interest on a recommendation. At a minimum, a broker-dealer is required to address the effect of conflicts of interest on a recommendation. At a minimum, a broker-dealer is required to address the effect of an identified conflict on a recommendation by disclosing the material facts associated with that conflict and by disclosing material limitations of the menu of securities when the conflict stems from such limitations. In certain cases, a broker-dealer is required to address the effect of an identified conflict by either mitigating the conflict, or, in certain cases, by eliminating certain sales practices.

The Conflict of Interest Obligation is intended to reduce the information asymmetry between a retail customer and a broker-dealer and its associated persons with respect to the broker-dealer's conflicts of interest or those of its associated persons that may have an effect on the recommendations provided to the retail customer. This disclosure may help the retail customer form a better assessment of the efficiency of the recommendation received. Moreover, reducing this information asymmetry may discourage broker-dealers from acting on incentives that differ from retail customer objectives.

Similarly, by addressing the effect of certain conflicts of interest through mitigation, the Conflict of Interest Obligation is intended to reduce the effect incentives created by those conflicts may have on a recommendation provided to the retail customer. Depending on how effective the mitigation method is in reducing these incentives, the efficiency of the recommendation provided to the retail customer may increase.

Similarly, by addressing the effect of certain conflicts of interest through elimination, the Conflict of Interest Obligation is intended to neutralize the effect of incentives created by those conflicts may have on a recommendation provided to the retail customer. In this case, the efficiency of the recommendations provided to the retail customer may increase.

The conflicts of interest that the broker-dealer or its associated persons have, and the incentives that these conflicts create, arise from, among other things, the manner in which broker-dealers generate revenue and the manner in which broker-dealers compensate their associated persons with respect to their dealings with retail customers.

The compensation arrangement between a broker-dealer and its associated persons may reflect the amount of revenues that the associated persons generate for the broker-dealer from activities performed, including providing recommendations to retail customers. Such arrangements between the broker-dealer and its associated persons may create incentives for the associated person to take actions consistent with maximizing the broker-dealer's objectives (e.g., expected profits). For instance, if an associated person's compensation from providing recommendations to retail customers is tied to the amount of revenues that the associated person generates for the broker-dealer, the associated person may have an incentive to recommend securities or investment strategies that would bring more revenue to the broker-dealer, relative to other comparable securities or investment strategies. Furthermore, even if the compensation arrangement does not create an explicit incentive for the associated person, the broker-dealer may direct the attention of the associated person to certain securities. For instance, even if the revenues that the broker-dealer receives when its associated persons provide recommendations to retail customers are not passed on to the associated persons, the broker-dealer's receipt of

compensation from some securities or their sponsors may lead the broker-dealer to emphasize to its associated persons the securities that are the source of such compensation.

The revenues that a broker-dealer receives when a retail customer acts on an investment recommendation may depend on the broker-dealer's compensation arrangement with the product sponsor. The broker-dealer may receive different compensation from different product sponsors for distributing comparable securities or investment strategies. If the objectives of the broker-dealer are tied to the amount of revenues it receives from recommended securities or investment strategies, the broker-dealer may have an incentive to advise only, or predominantly, on securities or investment strategies that come with attractive compensation arrangements and less so, or not at all, on other comparable securities or investment strategies. Accordingly, the incentives created by the compensation arrangements with the product sponsors may cause a broker-dealer to limit the menu of securities from which the broker-dealer or its associated persons make recommendations.

The conflicts of interest that can arise from the compensation arrangement between the broker-dealer and its associated persons, and from the compensation arrangement between the broker-dealer and the product sponsors, can create incentives that may affect the broker-dealer's or its associated persons' recommendations to retail customers. In certain circumstances, a

broker-dealer's conflicts of interest, or its associated persons' conflicts of interest, may result in recommendations that are not in the best interest of the retail customer.[1260]

As discussed above, in Section III.B.2, broker-dealers are currently subject to Commission and SRO regulations and rules that govern their business conduct. For example, with respect to the provision of advice, courts have found broker-dealers liable under the antifraud provisions of the federal securities laws for not giving "honest and complete information" or for not disclosing "material adverse facts of which it is aware" with regard to certain conflicts of interest, in certain circumstances.[1261] Furthermore, broker-dealers are generally prohibited from making an unsuitable recommendation to a customer.[1262]

In addition, broker-dealers may be liable under the Exchange Act for failure to supervise their associated persons when providing advice to retail customers.[1263] Broker-dealers are generally required to establish policies and procedures that are reasonably designed to prevent and detect violations of the federal securities laws and regulations, as well as applicable SRO rules. Broker-dealers are also required to establish and maintain systems for applying these

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1260 *See* FINRA Conflicts Report.

1261 *See* the Suitability Rule; *see also* 913 Study at 55 for a detailed discussion of the broker-dealers' disclosure obligations and liabilities under the current regulatory regime.

1262 *See* FINRA Rule 2111.03 (Recommended Strategies).

1263 *See* 913 Study at 74.

procedures (e.g., identifying and reviewing red flags with respect to the recommendations provided by their associated persons).[1264]

As discussed above, a number of studies and papers provide evidence suggesting that despite the current regulatory regime and observations that agency costs to retail customers from broker-dealer relationships may be trending downward, the effect of conflicts of interest on the provision of advice remains a concern.[1265] We also noted in Section III.A.2 above that, more generally, the conflicts of interest of the broker-dealer and its associated persons and the incentives that these conflicts create may result in agency costs for the retail customers that persist despite the current regulatory regime.

The Conflict of Interest Obligation in Regulation Best Interest is intended to reduce the agency costs associated with the conflicts of interest of the broker-dealers and its associated persons when they provide recommendations on securities transactions and investment strategies to retail customers. Below we discuss the economic implications of different requirements of this obligation, including their benefits and costs relative to the current regulatory regime.

1264 *Id.* at 75. In addition, FINRA Rule 3010 requires broker-dealers to establish and maintain a system to supervise the activities of their associated persons that is reasonably designed to achieve compliance with the applicable securities laws and regulations and FINRA rules. FINRA Rule 3120 requires broker-dealers to have a system of supervisory control policies and procedures that tests and verifies supervisory procedures.

1265 *See supra* Section III.B.3.c.

a. Overarching Obligation Related to Conflicts of Interest

The overarching obligation of the Conflict of Interest Obligation states that broker-dealers must establish, maintain, and enforce written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all conflicts of interest associated with recommendations to retail customers.

The requirement to establish written policies and procedures reasonably designed to identify conflicts of interest is a new requirement relative to the current regulatory regime. This requirement may impose costs on those broker-dealers that currently do not implement such policies and procedures voluntarily. These costs stem from the resources that a broker-dealer would have to expend to identify existing and potential conflicts of interest and to design policies and procedures that can reasonably identify and manage circumstances when a conflict of interest arises within the broker-dealer. These circumstances would have to take into account, among other things, how the broker-dealer generates revenue from providing recommendations to retail customers and how associated persons of the broker-dealer are compensated for providing recommendations. In addition, these circumstances would have to account for the limitations of themenu of securities from which broker-dealers provide recommendations. Furthermore, broker-dealers may incur costs of reviewing and updating such policies and procedures as new conflicts of interest arise or as new circumstances develop that may cause the broker-dealer to identify an existing conflict of interest. The Commission is providing below a quantitative estimate of the cost to broker-dealers associated with designing and updating such policies and procedures under certain assumptions

The requirement to establish policies and procedures reasonably designed to identify conflicts of interest may also create benefits for retail customers. As noted above, the policies

and procedures would require broker-dealers to: (1) identify existing conflicts of interest and new circumstances in which an existing conflict of interest may arise, and (2) new conflicts of interest and the circumstances in which they may arise. Having a process in place to identify and address the conflicts of interest associated with a recommendation at the time the recommendation is made to a retail customer would reduce the likelihood that a broker-dealer may fail to disclose material facts relating to conflicts of interest. Thus, the process a broker-dealer develops as a result of complying with the Conflict of Interest Obligation may improve the quality of the content of the disclosure of conflicts of interest that may affect a recommendation. To the extent such disclosure helps retail customers make a better assessment of the efficiency of the recommendation they receive, the requirement may benefit the retail customers.

The Commission continues to believe that it is not possible to meaningfully quantify the potential costs and benefits of the Conflict of Interest Obligations because such analysis would depend on many contingent factors that render any estimate insufficiently precise to inform our policy choices.[1266] For example, such an analysis of the Conflict of Interest Obligation would require strong assumptions about the circumstances under which a broker-dealer may fail to

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[1266] *See* discussion following *supra* footnote 1156 for a general discussion of these factors. *See also infra* Section III.C.7, where we have endeavored to quantify some of the potential benefits of Regulation Best Interest based on many assumptions.

identify a given conflict of interest, and also about the extent to which the disclosure of the conflicts of interest may enhance decision making for retail customers.

The requirement to establish policies and procedures reasonably designed to, at a minimum, disclose identified conflicts of interest may help a retail customer evaluate the efficiency of the recommendation provided by a broker-dealer and its associated persons, and may affect the retail customer's decision of whether, and how, to act on the recommendation. As noted in Section III.A.2 above, reducing the information asymmetry between a retail customer and a broker-dealer and its associated persons may help the retail customer form a better assessment of the efficiency of the received recommendation.

Disclosure requirements generally are intended to reduce information asymmetries between transacting parties. Whether such a reduction is likely to occur depends largely on the effectiveness of the disclosure. If the disclosure provides new information, transacting parties may make more informed decisions than they would without this new information, and, from this perspective, the disclosure may be effective. However, disclosure can be effective even if no new information is provided, to the extent the form and manner in which a disclosure requirement reaches the transacting parties facilitates a more informed decision. There is extensive academic literature on the factors that contribute to disclosure effectiveness.[1267] Among these factors, those

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[1267] *See supra* Section III.B.4.c for a detailed discussion of the academic literature on disclosure effectiveness.

associated with bounded rationality, including financial literacy, are generally important.[1268] In particular, disclosure effectiveness generally increases with the level of financial literacy of the transacting party.[1269] It is also possible that if a broker-dealer's retail customers have different degrees of financial literacy, the potential anticipated reaction of the retail customers that are financially literate to the disclosure of conflicts of interest may cause the broker-dealer to choose to eliminate certain conflicts, which, in turn, would benefit the population of retail customers that are less financially literate. Specifically, the requirement to establish policies and procedures reasonably designed to, at a minimum, disclose identified conflicts of interest may have a deterrent effect on some broker-dealers to the extent that they anticipate that disclosing material facts about certain conflicts of interest may be effective in dissuading certain retail customers from seeking or accepting recommendations from their associated persons in the future. As noted above, such broker-dealers may choose to eliminate those conflicts instead.

i. Disclosing Conflicts of Interest

The requirement under the Conflict of Interest Obligation to develop reasonably designed policies and procedures to, at a minimum, disclose identified conflicts of interest would obligate a broker-dealer to provide information (e.g., material facts) about its conflicts of interest and those that its associated persons have when making a recommendation to a retail customer. As

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1268 *Id.*

1269 *Id.*

discussed above, this information may already be disclosed under the regulatory baseline and by broker-dealers that adopt best practices. However, it is currently not clear in what form and what manner this disclosure reaches the retail customer.[1270] Under Regulation Best Interest, the Conflict of Interest Obligation is intended to require that such disclosure reach the retail customer more directly and in a more timely manner.[1271] In addition, the material facts disclosed may increase the salience of the conflicts of interest to retail customers as being a potential factor contributing to an associated person's recommendation. Salience detection is a key feature of human cognition allowing individuals to focus their limited mental resources on a subset of the available information and causing them to over-weight this information in their decision making processes.[1272] Limited attention among individuals increases the importance of focusing on salient disclosure signals. Research suggests that increasing signal salience is particularly helpful in reducing limited attention of consumers with lower education levels and financial literacy.[1273] To the extent that this manner of disclosure and the associated increase in salience results in more informed decisions with respect to whether to act on a received recommendation,

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1270 *See e.g.*, 913 Study.

1271 Broker-dealers satisfy their current disclosure obligations in the account opening agreement, account statements, and information made public on their websites.

1272 *See* Daniel Kahneman, THINKING, FAST AND SLOW (2013); Susan T. Fiske & Shelley E. Taylor, SOCIAL COGNITION: FROM BRAINS TO CULTURE (3rd ed. 2017).

1273 *See, e.g.*, Victor Stango & Jonathan Zinman, *Limited and Varying Consumer Attention: Evidence from Shocks to the Salience of Bank Overdraft Fees*, 27 REV. FIN. STUD. 990 (2014).

the disclosure requirement resulting from the Conflict of Interest Obligation will benefit retail customers.

It is also possible that the disclosure of material facts about a broker-dealer's conflicts of interest or those of its associated persons related to a recommendation may not benefit the retail customer receiving that recommendation. As noted by one commenter, the academic literature on disclosure effectiveness notes that in certain circumstances, disclosure of financial information may induce a "panhandler effect", whereby disclosure increases the pressure to comply with the advice if the advisee (e.g., the retail customer) feels obliged to satisfy the financial interest of the advice provider (e.g., the associated person).[1274]

ii. Elimination of Conflicts of Interest

The policies and procedures that broker-dealers will need to maintain and implement to comply with the Conflict of Interest Obligation will also give them the option of addressing conflicts of interest associated with recommendations by eliminating such conflicts entirely,

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[1274] *See, e.g.*, EPI Letter at 11, noting that "[a]s the SEC itself noted in its analysis of one of the proposed regulations, disclosure may even induce a 'panhandler effect,' whereby clients may go through with a transaction in response to social pressure to meet the professional's financial interests." The Commenter also notes that generally disclosure may not incentivize a financial professional to change her behavior: "The SEC also noted that disclosure could have an effect on the behavior of financial professionals through 'moral licensing'—the belief that they have already fulfilled their moral obligations through disclosure, and 'strategic biasing'—the desire to compensate for an anticipated loss of profit from disclosure." As discussed above, Regulation Best Interest recognizes that certain conflicts of interest cannot be reasonably addressed with disclosure alone. *See also supra* Section III.B.4.c, which discusses in more detail these effects.

rather than just disclosing them to the retail customer. Depending on the effectiveness of the policies and procedures that a broker-dealer implements to comply with the Conflict of Interest Obligation, conflicts of interest that are not required to be eliminated and that remain may still have a significant effect on an associated person's recommendation. If a broker-dealer considers that the effect of a conflict of interest on the recommendations of its associated persons cannot be adequately addressed by the broker-dealer, as required by the Conflict of Interest Obligation (discussed further below), the broker-dealer may consider modifying its practices to eliminate that conflict. By eliminating a conflict, the broker-dealer would neutralize the effect of this conflict on the recommendations provided by the broker-dealer or its associated persons to retail customers. The absence of this conflict of interest when the associated person is considering reasonably available alternatives for a recommendation to a retail customer, as noted above in the discussion of the Care Obligation, would likely result in an increase in the efficiency of the customers. As discussed above in Section III.A.2, this outcome would be consistent with the goals of Regulation Best Interest by reducing the agency costs associated with an associated person's incentives created by these conflicts of interest, which would benefit the retail customer.

Furthermore, the option to address conflicts of interest through elimination allows broker-dealers to reduce the compliance costs associated with managing conflicts of interest. For example, if a broker-dealer determines it is too costly to just disclose a conflict of interest as required under the Conflict of Interest Obligation, the broker-dealer could choose to eliminate the conflict. On the other hand, by eliminating a conflict of interest, a broker-dealer may forgo the potential revenues associated with that conflict of interest.

b. Mitigation of Certain Incentives to the Associated Persons

The requirement to establish, maintain, and enforce written policies and procedures reasonably designed to identify and mitigate conflicts of interest that create an incentive for the associated person of the broker-dealer to place the interest of the broker-dealer or the associated person ahead of the interest of the retail customer will likely affect the relationship between the broker-dealer and its associated persons, the menu of securities that the broker-dealer makes available to its associated persons, and the recommendations that the broker-dealer and its associated persons provide to retail customers. In the employment relationship between a broker-dealer and its associated persons, the broker-dealer generally hires and compensates associated persons to perform certain services (e.g., providing recommendations on securities transactions and investment strategies to retail customers) using the broker-dealer's framework (e.g., policies and procedures to ensure compliance with applicable laws and rules, supervisory systems that monitor for potential violations of policies and procedures, etc.). The compensation that the associated person receives from the broker-dealer may reflect the level of effort that the broker-dealer expects the associated person to exert when performing a service, given the broker-dealer's infrastructure. As noted above, the broker-dealer may also structure the associated person's compensation to create incentives that are consistent with maximizing the broker-dealer's objectives.

The requirement to establish, maintain, and enforce written policies and procedures reasonably designed to identify and mitigate conflicts of interest that create an incentive for the associated person of the broker-dealer to put the interest of the broker-dealer or the associated person ahead of the interest of the retail customer may affect the employment relationship between the broker-dealer and the associated person in several ways. First, the requirement may

change a broker-dealer's existing policies and procedures that are designed to achieve compliance with the regulatory baseline as well as the supervisory systems that allow the broker-dealer to monitor for potential violations by the associated persons of these policies and procedures. To this end, broker-dealers will need to consider the amount of time and level of resources to devote to design and establish policies and procedures that seek to reduce the likelihood of an associated person placing its interest or the interest of the broker-dealer ahead of the interests of a retail customer when providing recommendations to retail customers.

Another way that this requirement may affect the employment relationship between the broker-dealer and the associated person is by changing the level of effort that the associated person would have to exert to ensure that all recommendations supplied to retail customers are compliant with the Conflict of Interest Obligation. As a corollary, this requirement may also affect the level of effort that a supervisor would have to exert to ensure that the recommendations supplied by its associated persons to a retail customer comply with the obligations of Regulation Best Interest.

As discussed above in the context of the Care Obligation, an associated person would have to not only consider a number of factors when making a recommendation to a retail customer, but also ensure that the recommendation is in the best interest of the retail customer. The determination that a recommendation is in the retail customer's best interest may depend on the conflicts of interest that exist at the time the associated person makes the recommendation, and, importantly, on how the broker-dealer complies with the requirement to establish, maintain, and enforce policies and procedures reasonably designed to identify and mitigate or eliminate conflicts of interest that create an incentive for the associated person to put the interest of the broker-dealer or the associated person ahead of the interest of the retail customer. It is possible

that more effective policies and procedures may lower the level of effort an associated person would have to exert to have a reasonable basis to believe that recommendations are compliant with Regulation Best Interest, in the sense that a supervisor or the broker-dealer would determine whether the effect of the associated person's or the broker-dealer's conflicts of interest is reduced to the point where the incentives created by these conflicts do not have a negative effect on the recommendations. However, the potential increase in the supervisor's level of effort may substitute for the potential decrease in the associated person's level of effort.

One commenter had concerns about the discussion in the Proposing Release about the effect of the compensation arrangements between the broker-dealer and the associated person on the effort exerted by the associated person when providing a recommendation. [1275] This commenter stated that if the compensation leads to lower effort, the associated person would not make recommendations that are in the retail customer's best interest. As discussed above, the Commission notes that the relationship between the effort exerted to make a recommendation and the efficiency of the recommendation is complex, and that lower effort may not necessarily be inconsistent with increasing the efficiency of the recommendation.

Finally, the Conflict of Interest Obligation may affect the compensation arrangement between the broker-dealer and its associated persons. Certain compensation arrangements may create incentives for an associated person to place his or her interest of the interest of the broker-

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[1275] *See* AARP August 2018 Letter.

dealer ahead of the interest of the customer, and therefore create conflicts of interest for the broker-dealer's associated persons. For example, as discussed above in Section III.B.1.f, broker-dealers commonly compensate their associated persons based on commissions and performance-based awards. These compensation arrangements create incentives for associated persons to recommend securities or investment strategies that generate more commissions to the broker-dealer and potentially themselves over other securities or investment strategies.

The Conflict of Interest Obligation requires a broker-dealer to have policies and procedures that are reasonably designed to identify and disclose and mitigate, or eliminate, any conflicts of interest associated with recommendations that create an incentive for the associated person or the firm to place the interest of the associated person or the firm ahead of the interest of the retail customer, including conflicts of interest that arise from compensation arrangements between broker-dealers and their associated persons. Depending on how a broker-dealer complies with the Conflict of Interest Obligation, compensation arrangements between broker-dealers and their associated persons may change as a result of establishing these policies and procedures. For example, as discussed above in Section III.B.2.e, in response to the DOL Fiduciary Rule, which among other things, was designed to restrict broker-dealer activities and reduce the conflicts of interest of a broker-dealer and those of its associated persons, some broker-dealers altered the compensation for their associated persons. Specifically, some broker-dealers chose to equalize commissions and deferred sales charges charged across similar

securities or investment strategies. Others chose to restrict or eliminate sales quotas, contests, special awards, and bonuses, including deferred bonuses as part of the recruitment efforts.[1276] It is possible that some broker-dealers may choose to comply with the Conflict of Interest Obligation by establishing policies and procedures that would address conflicts using these or similar methods. It is also possible that some broker-dealers may rely on existing policies and procedures that address conflicts through methods such as compliance and supervisory systems that are consistent with the Conflict of Interest Obligation.

Some of these methods may reduce the overall compensation of the associated person from providing recommendations (e.g., altering certain bonuses). The same methods or others (e.g., altering deferred recruiting bonuses) may complicate a broker-dealer's hiring of new associated persons. However, to the extent that these methods address the conflicts of interest of a broker-dealer or those of its associated persons in an effective manner, these methods may enhance the efficiency of the recommendations provided by a broker-dealer and its associated persons, and, therefore benefit retail customers.

[1276] However, we understand that following the decision by the Fifth Circuit to vacate the DOL Fiduciary Rule, some broker-dealers may have reverted back to compensation arrangements that they had in place prior to the DOL Fiduciary Rule. For instance, as discussed in Section III.B.2.e.ii, *supra*, some broker-dealers reinstated their deferred recruiting bonuses.

In general, if a broker-dealer implements policies and procedures pursuant to the Conflict of Interest Obligation that may result in a significant reduction in the overall compensation that an associated person receives from providing recommendations, the associated person may have an incentive to register as an investment adviser, if not already registered as one, and provide advice mostly or only in an investment adviser capacity.

To the extent broker-dealers establish, maintain, and enforce policies and procedures that are effective at reducing the incentives of an associated person to put the interest of the broker-dealer or the associated person ahead of the interest of the retail customer, the Conflict of Interest Obligation would reduce the effect of these conflicts on the recommendations provided by associated persons to retail customers. In this way, complying with the Conflict of Interest Obligation would increase the efficiency of the recommendations for retail customers, relative to the regulatory baseline. This, in turn, would reduce the agency costs associated with the broker-dealer's and its associated persons' incentives that are created by their conflicts of interest. Lower agency costs at these broker-dealers would benefit retail customers.

One commenter noted that the size of these benefits of Regulation Best Interest should be quantified relative to the baseline that includes the current regulatory regime as well as current practices.[1277] The Commission agrees with the commenter and notes that, as discussed in Section III.B, broker-dealers may already have compliance and supervisory systems in place that are

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[1277] *See* CFA August 2018 Letter.

effective at reducing to a reasonable extent the effect of an associated person's conflicts of interest on the recommendations provided to retail customers.[1278] Therefore, for the retail customers of these broker-dealers, the potential benefits above may be small. In contrast, for the retail customers of the broker-dealers that are not currently addressing conflicts of interest in a manner consistent with Regulation Best Interest, the potential benefits above may be large.

This commenter further stated that the economic analysis in the Proposing Release did not provide a thorough discussion of the relationship between the broker-dealer and its associated persons with a focus on the incentives of the associated persons.[1279] The Commission notes that the analysis above about the incentives of the associated persons expands the analysis in the Proposing Release and establishes a clear link between compensation and incentives.

As noted in the economic analysis of the Proposing Release,[1280] broker-dealers may also adjust their menus of securities in response to the requirement to establish, maintain, and enforce written policies and procedures reasonably designed to identify and mitigate conflicts of interest that create an incentive for the associated person to place his or her interest or the interest of the broker-dealer ahead of the interest of the retail customer. It is possible that some broker-dealers may decide to expand their offerings to better comply with the process required pursuant to the Conflict of Interest Obligation. For instance, broker-dealers that currently offer advice only on a

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1278 *See* FINRA Conflicts Report.

1279 *See* CFA August 2018 Letter.

1280 *See* Proposing Release at 21658.

limited set of securities (e.g., proprietary securities) would have to disclose and evaluate their menu of securities to ensure that their policies and procedures regarding their limited menus of securities and the disclosures of any conflicts associated with such limitations do not result in recommendations that place the interest of the broker-dealer or its associated persons ahead of the retail customer's interest.

Broker-dealers may also manage conflicts of interest by limiting their menu of securities on which they offer recommendations. Broker-dealers may prefer a limited menu of securities to better mitigate the potential costs associated with compliance of Regulation Best Interest. For instance, a limited menu of securities may result in more homogenous product fees across comparable securities or investment strategies, which would help reduce the effect of certain conflicts of interest on the recommendations provided to retail customers. Broker-dealers may also respond by limiting their menus of securities because they may have conflicts of interest due to variation in the compensation they receive from product sponsors, as discussed above.

It is possible that complying with the Conflict of Interest Obligation in this manner may result in securities menus that limit an associated person's choices of investments when providing a recommendation to a retail customer.[1281] However, as discussed below, the requirements of the Conflict of Interest Obligation and the Care Obligation are intended to

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[1281] *See supra* Section II.C.2.

reduce the likelihood that limitations on securities menus result in recommendations that are not in the best interest of the retail customer.[1282]

It is also possible that broker-dealers that limit their menus of securities in response to the Conflict of Interest Obligation may eliminate securities or investment strategies that are inferior relative to other securities or investment strategies in terms of performance and costs. Recommendations based on menus of securities that do not contain inferior securities or investment strategies are more likely to be efficient for the retail customer. To the extent broker-dealers eliminate inferior investments from their securities menus as a result of complying with the Conflict of Interest Obligation, Regulation Best Interest would provide a benefit for the retail customers of these broker-dealers.

Broker-dealers may pass on some of the compliance costs to their retail customers. For instance, broker-dealers may increase their fees on the services that they provide to retail customers as part of the relationship, or may adopt new fees. Alternatively, broker-dealers may seek to renegotiate their compensation arrangements with the product sponsors in the hopes of extracting greater compensation (e.g., more attractive revenue-sharing agreements), relative to current practices. The likelihood of a favorable outcome for the broker-dealers may depend on whether product sponsors can charge their retail customers higher fees. However, it is likely that

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[1282] For example, if none of the securities on the menu would be in the best interest of the retail customer in a given set of circumstances, the associated person may not recommend any of the securities on the menu to the retail customer.

product sponsors are already charging fees that are privately optimal (e.g., maximize their revenue net of costs), and thus any deviations from these fees would lead to a suboptimal outcome for the product sponsors. In other words, product sponsors may not have an incentive to increase their fees.

A number of commenters stated that policies and procedures that address how broker-dealers manage conflicts of interest relating to limited menus of securities could impose costs on a retail customer when all securities on the menu have high fees or create a benefit for retail customers if securities with high fees are eliminated.[1283] As noted in the Proposing Release and above, the Commission acknowledges the benefits to the retail customers of the broker-dealers that comply with Regulation Best Interest by eliminating inferior securities or investment strategies. The Commission also acknowledges the potential costs of limited menus of securities by expanding the Conflict of Interest Obligation to include requirements that would address specifically limited menus of securities and by providing a detailed analysis of the economic implications of these requirements, below.

c. Material Limitations on Recommendations to Retail Customers

The Conflict of Interest Obligation includes a requirement that specifically addresses material limitations on recommendations to retail customer (e.g., offering only proprietary or

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[1283] *See, e.g.*, CFA August 2018 Letter; AARP August 2018 Letter; EPI Letter; Better Markets August 2018 Letter.

other limited range of securities). This provision requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose any material limitations placed on securities or investment strategies that may be recommended to a retail investor and any conflicts of interest associated with such limitations in accordance with the Disclosure Obligation. It further requires such policies and procedures to be reasonably designed to prevent such limitations and associated conflicts of interest from causing the broker-dealer or its associated persons to make recommendations that place the interest of the broker-dealer or associated persons ahead of the interest of the retail customer.

As noted above, broker-dealers may limit their menus of securities in response to certain requirements of the Conflict of Interest Obligation. The requirements that address limited menus of securities are designed to help ensure that these limitations and associated conflicts of interest do not create incentives for the broker-dealer or its associated persons to make recommendations that are not in the best interest of the retail customer. The second aspect of the requirement would seek to ensure that the menu of securities is not limited to the point where it restricts a broker-dealer and its associated persons from complying with the Care Obligation, and in particular with the requirement to provide recommendations that are in the customer's best interest.[1284] To the extent these requirements reduce the effect of the limitations of the menu of securities and the associated conflicts of interest on the recommendations provided by a broker-

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[1284] Broker-dealers that offer a limited menu of securities may not be able to offer recommendations to certain clients. *See also supra* footnote 1282.

dealer or its associated persons, the Conflict of Interest Obligation would result in recommendations that are more likely to be efficient, relative to the baseline.

The requirements that address limitations of the menu of securities may have additional implications for certain product markets, and ultimately, retail customers. To better understand these implications we focus the discussion on the market for mutual funds.

As discussed in Section III.B.3, academic literature has noted that in certain product markets, such as mutual funds, the different distribution channels that product sponsors use to reach the retail customer may cause these markets to fragment. In the market for mutual fund products, some products are sold to retail customers only through broker-dealers—the so-called "broker-sold" distribution channel—while other products are sold directly to retail customers—the so-called "direct-sold" distribution channel.[1285] The products that are sold through the broker-sold channel usually carry higher fees relative to comparable products that are sold through the direct-sold channel.[1286] Higher fees on the broker-sold products reflect broker-dealers' compensation for distributing the product. In general, all transactions linked to the

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[1285] In this discussion, the broker-sold distribution channel includes sales that are the result of a recommendation provided by the broker-dealer but may also include sales that are solicited by the retail customer where no advice or recommendation was provided by the broker-dealer (i.e., unadvised sales). The direct-sold distribution channel includes unadvised sales through broker-dealer open platforms as well as sales that the retail customer solicits directly from the product sponsor. Investment advisers may also access products through the direct-sold distribution channel.

[1286] *See, e.g.*, Del Guercio & Reuter (2014).

broker-sold distribution channel are triggered by a recommendation provided by an associated person of the broker-dealer. Most product sponsors currently rely on one of the two channels to distribute their products, but not on both.[1287]

A retail customer that has an account with a broker-dealer that provides advice is not necessarily constrained to accessing products only through the broker-sold channel. A retail customer could access products from the direct-sold channel to transact on his or her own (for example, if the broker-dealer may not provide recommendations on a particular product).[1288] A retail customer who has access to products from both distribution channels and who understands the effect of fees on a product's performance may prefer to access a product through the broker-sold channel if, for example, the combined cost of identifying (e.g., search costs) and accessing comparable direct-sold products (e.g., product fee) is higher than the total cost of the broker-sold product recommended by the associated person of the broker-dealer.[1289] As more direct-sold

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[1287] *See, e.g.*, Del Guercio & Reuter (2014), *supra* footnote 1081, and Reuter (2015), *supra* footnote 1095.

[1288] A retail customer could also access securities through financial professionals that are not broker-dealers, including investment advisers.

[1289] Some broker-dealers may offer securities to retail customers through both distribution channels, but these broker-dealers provide recommendations only on securities offered through the broker-sold channel. For example, some broker-dealers with open platforms may only provide recommendations on proprietary securities.

products enter the market,[1290] the retail customer's cost of identifying[1291] direct-sold products that are comparable alternatives to a broker-sold product recommended by an associated person of the broker-dealer may become lower.[1292] In turn, the retail customer's demand for broker-sold products may decline.[1293]

According to economic first principles, when enough retail customers exhibit a preference for direct-sold products over broker-sold products, the aggregate demand for broker-

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1290 *See, e.g.*, ICI Letter, which shows an increasing trend in the number of mutual funds with no 12b-1 fees over the past 10 years. These funds are available through the direct-sold channel.

1291 Broker-dealers with open platforms that allow retail customers to access securities on this platform without a recommendation from the broker-dealer and its associated persons generally provide extensive research and analytical tools. The Commission has recently adopted rule amendments that address research reports that broker-dealers make available to their retail customers. *See* Covered Investment Fund Research Reports, Release 33-10580 (Nov 30, 2018); 83 FR 64180 (Dec. 13, 2018).

1292 *See, e.g.*, Ali Hortacsu & Chad Sylverson, *Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds*, 119 Q. J. ECON. 403 (2004), who estimate an investor's search costs for S&P500 index funds and show that, as the number of S&P500 index funds increased over their sample period spanning 1995 to 2000, the investor's search costs generally declined. The authors further show that this downward trend was driven by funds that are in lower end of the search cost distribution and that these funds were mostly no-load funds. These no-load funds are usually available through the direct-sold channel.

1293 However, a retail customer may value the services provided by a broker-dealer that extend beyond the provision of recommendations on securities transactions and investment strategies and continue to maintain an account with the broker-dealer. To counter the potential decline in the demand for broker-sold products, a broker-dealer may respond by offering more services and increasing the fee for the package of services or by trying to shift the retail customer to a potentially more profitable advisory account (to the extent that the broker-dealer offers this type of accounts).

sold products should decline. To remain competitive, product sponsors that rely on the broker-sold channel to distribute their products would have to lower the fees on their products. Lower fees on broker-sold products may result in lower compensation for broker-dealers and their associated persons from providing recommendations on these products. Lower fees on broker-sold products would benefit retail customers who access mutual fund products through the broker-sold channel.

This market mechanism would allow retail customers' demand to affect how product sponsors compensate broker-dealers for recommending broker-sold products. While this mechanism is currently available to retail customers and is considered generally effective, it is not clear how effective this mechanism is in all aspects of the market, particularly in the short run.[1294] As noted by one commenter, the expense ratio for domestic equity mutual funds declined

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[1294] Recent academic research questions the effectiveness of the market mechanism, at least in the short run. *See. e.g.*, Yang Sun, *Does Competition Protect Retail Investors? Role of Financial Advice* (Working Paper, Apr. 2017), *available at* https://coller.tau.ac.il/sites/coller-english.tau.ac.il/files/media_server/Recanati/management/conferences/finance/2017/61.pdf. This research shows that the sudden entry of several low-cost index funds caused direct-sold actively managed funds with similar investment objectives to cut their fees by 6.4 basis points. In contrast, broker-sold actively managed funds with similar investment objectives as the new entrant funds increased their fees by 12.2 basis points. The study further shows that while some of the fee increase in the broker-sold funds is accompanied by increased levels of active management, most of the fee increase (more than 60%) was passed on to broker-dealers. The author argues that the broker-sold actively managed funds are able to increase their fees only to the extent that they can signal to the market that they are not employing strategies that mimic index funds.

from 0.86 percent in 2007 to 0.59 percent in 2017, a 31% reduction over the ten year period.[1295] This commenter further notes that this downward trend in expense ratios reflects, among other things, a "long-running shift by investors toward lower-cost funds." Because the number of low-cost funds that enter the market over the period 2007-2017 has increased substantially, the assessment of this commenter would appear to be consistent with the market mechanism being effective in the long run.[1296]

As noted above, the effectiveness of the market mechanism may depend on a number of factors, including the retail customer's ability to understand the effect of fees on the performance of a product and willingness to shop around for comparable products, the product sponsor's ability to signal how its broker-sold products stand out among comparable products, and the broker-dealer's menu and the disclosure about potential limitations of this menu.[1297]

The Conflict of Interest Obligation may improve the effectiveness of this market mechanism through the requirement that broker-dealers establish, maintain, and implement written policies and procedures reasonably designed to identify and disclose all material limitations of products that may be recommended and any associated conflicts of interest. This

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1295 *See* ICI Letter.

1296 *Id.* at 42.

1297 As noted in *supra* footnote 1292, the effectiveness of this market mechanism may also depend on whether broker-dealers offer advisory accounts and whether these broker-dealers can convince retail customers to switch to an advisory account rather than to a self-directed account.

requirement would result in disclosures that, while not necessarily new relative to the regulatory baseline, may increase the salience of the limitations of product menus and the associated conflicts of interest for the retail customers.[1298] The added focus on these limitations may cause some retail customers to question whether the recommendations that they are receiving are taking into consideration a reasonable set of alternatives. Thus, this disclosure may encourage retail customers to shop for comparable products that they may prefer (e.g., based on cost factors) over the broker-sold products that are being recommended to them.

As an example, a broker-dealer that is providing recommendations only for proprietary products would have to disclose, the material limitation that the products on the menu are all proprietary, and the material fact of the conflict of interest that the broker-dealer and its associated persons are being compensated for selling these products. As discussed above in Section II.C.3.f, there are a number of other potential conflicts of interest associated with proprietary products. While broker-dealers may disclose this information under the regulatory baseline, it is not clear the manner in which this disclosure currently reaches the retail customer.[1299] The new required disclosure with respect to conflicts of interest (under the Disclosure Obligation) is intended to be more comprehensive and more specific, and is also intended to reach the retail customer more directly. From this perspective, the disclosure of the

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1298 *See supra* footnote 1272 and accompanying text.

1299 *See, e.g.*, 913 Study.

limitations of the product menu and its associated conflict of interest may better inform retail customers' choices and, therefore, may be more effective, compared to current disclosure forms of the same information. While, generally, the effectiveness of disclosure depends on many factors that are well known in the academic literature, the disclosure requirement of the Conflict of Interest Obligation may also depend on the range of material facts that the broker-dealer deems necessary to disclose in order to be in compliance with the obligation.[1300]

The Conflict of Interest Obligation addresses limited product menus by requiring that broker-dealers take measures through reasonably designed written policies and procedures to evaluate and prevent the limitations and the associated conflicts of interest from causing associated persons of the broker-dealer to make recommendations that are inconsistent with the requirements of Regulation Best Interest. The requirement seeks to address specific firm-level conflicts—namely, the conflicts associated with the establishment of a product menu—which are likely to affect recommendations made to retail customers and may result in recommendations that place the interest of the broker-dealer or its associated persons ahead of the interest of the retail customer.

This requirement may have a direct effect on the relationship between broker-dealers and product sponsors. To the extent that enough broker-dealers decide to no longer offer recommendations on certain types of products that carry higher fees (i.e., exclude them from the

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[1300] *See supra* Section III.B.4.c for a detailed discussion of the academic literature on disclosure effectiveness.

menus), the aggregate demand for such products may decline. Product sponsors that face declining demand for some of their products may respond by lowering the fees on these products or by repackaging these products into new and more competitive products that may again draw the interest of the broker-dealers.

d. Elimination of Certain Sales Practices

As part of the Conflict of Interest Obligation in Regulation Best Interest, broker-dealers are required to establish, maintain, and enforce written policies and procedures reasonably designed to 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. The Commission believes that the conflicts of interest associated with these practices that may create high-pressure situations for the associated persons of the broker-dealer to recommend a specific security over another cannot be reasonably addressed through disclosure and mitigation and should be addressed through elimination in order to comply with the requirements of Regulation Best Interest.[1301]

Relative to the regulatory baseline, this requirement would provide benefits to retail customers. Conflicts of interest that create incentives for the associated persons to recommend a specific security (or specific types of securities) over another are likely to have a significant

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[1301] *See also* the discussion in Section II.C.3.g, *supra*.

effect on an associated person's recommendation, even if such conflicts were disclosed and mitigated via policies and procedures established, maintained and enforced by the broker-dealer. By explicitly requiring policies and procedures reasonably designed to eliminate sales practices that may result in such conflicts, the requirement should neutralize the effect of these conflicts on the recommendations provided by associated persons to retail customers. The absence of these conflicts when the associated person is considering reasonably available alternatives for a recommendation to a retail customer, as noted in the discussion of the Care Obligation, may increase the efficiency of the recommendation for their retail customers. As discussed above in Section III.A.2, this outcome is consistent with Regulation Best Interest reducing the agency costs associated with a broker-dealer's incentives or the incentives of its associated persons created by these conflicts of interest, which, in turn, would benefit the retail customer.

The requirement to establish policies and procedures reasonably designed to eliminate certain sales practices may reduce the total compensation that a broker-dealer and its associated person receives from providing recommendations to retail customers. As discussed above, to the extent that the reduction in an associated person's total compensation is sufficiently large, the associated person may have an incentive to register as an investment adviser and provide investment advice only in his or her advisory capacity. Furthermore, the potential decline in the total compensation of an associated person of the broker-dealer due to this requirement may dissuade financial professionals from providing advice in the capacity of a broker-dealer, and as a result, broker-dealers may find it more difficult to hire new associated persons, relative to the baseline.

In addition, the types of sales practices that this requirement is meant to address generally create incentives for associated persons to recommend certain types of securities or investment

strategies over certain time periods over other types of securities or investment strategies. By requiring broker-dealers to establish policies and procedures reasonably designed to eliminate certain sales practices that create these types of incentives, broker-dealers may experience a reduction in the revenue stream associated with certain securities or investment strategies. Thus, through this requirement, Regulation Best Interest may impose a cost on the broker-dealers that currently rely on these types of practices in order to incentivize sales. On the other hand, retail customers who have born costs associated with such practices will benefit from the cessation of these sales practices.

As discussed above, while we are unable to quantify the full costs of Regulation Best Interest, including the Conflict of Interest Obligation, we are able to estimate some of the costs associated with the Conflict of Interest Obligation, specifically the costs related to information collection requirements as defined by the Paperwork Reduction Act. As discussed further in Section IV.B.1, the Commission believes that broker-dealers would update their policies and procedures to comply with this requirement and would incur an initial aggregate burden of approximately 128,160 hours and an additional initial aggregate cost of approximately $25 million, as well as an ongoing aggregate annualized burden of approximately 27,900 hours, and an ongoing aggregate annualized cost of approximately $2.91 million.[1302] Furthermore, the

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[1302] These estimates are based on the following calculations: 120,600 hours + 7,560 hours = 128,160 hours; $10 million + $15 million = $25 million; and 24,120 hours + 3,780 hours = 27,900 hours. As discussed in more detail in *infra* Section V.D, 120,600 hours and

Commission believes that in order to identify conflicts of interest and determine whether the conflicts are material, broker-dealers would incur an initial aggregate burden of approximately 69,150 hours and an additional initial aggregate cost of approximately $15.71 million as well as an ongoing aggregate annualized burden of approximately 27,660 hours.[1303] Thus, we estimate the Conflict of Interest Obligation of proposed Regulation Best Interest would impose an initial aggregate cost of at least $110.73 million and an ongoing aggregate annual cost of at least $20.44 million on broker-dealers.[1304]

7,560 hours are preliminary estimates for the initial aggregate burdens for large and small broker-dealers, respectively, $10 million and $15 million are preliminary estimates for the initial aggregate costs for large and small broker-dealers, respectively, and 24,120 hours and 3,780 hours are preliminary estimates for the ongoing aggregate burdens for large and small broker-dealers, respectively.

1303 The estimate of the initial aggregate burden is based on the following calculations: 13,830 hours + 55,320 hours = 69,150 hours, where, as discussed in more detail in Section V.D, 13,830 hours and 55,320 hours are estimates for the initial aggregate burdens for identifying conflicts of interest and determining whether the conflicts are material for all broker-dealers, respectively.

1304 These estimates are calculated as follows: (90,450 hours of in-house legal counsel) x ($415.72/hour for in-house counsel) + (27,660 hours for in-house compliance counsel) x ($365.39/hour for in-house compliance counsel) + (27,660 hours for identifying conflicts of interest) x ($229.74/hour for business line personnel) + (51,540 hours for review of policies and procedures) x ($309.60/hour for in-house compliance manager) + (50,302 hours for outside legal counsel) x ($497/hour for outside legal counsel) + (55,317 hours for modifying existing technology) x ($284/hour for outside senior programmer) = $110.73 million, and (8,040 hours of in-house legal counsel) x ($415.72/hour for in-house counsel) + (21,870 hours for in-house compliance counsel) x ($365.39/hour for in-house compliance counsel) + (21,870 hours for identifying conflicts of interest) x ($229.74/hour for business line personnel) + (3,780 hours for review of policies and procedures) x ($309.60/hour for compliance manager) + (3,783 hours for outside legal

5. Compliance Obligation

The Compliance Obligation of Regulation Best Interest requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.[1305] This obligation creates an affirmative obligation under the Exchange Act with respect to Regulation Best Interest as a whole, while providing sufficient flexibility to allow broker-dealers to establish compliance policies and procedures that accommodate a broad range of business models.[1306]

The Compliance Obligation is designed to ensure that broker-dealers have internal controls in place to prevent violations of Regulation Best Interest. The policies and procedures required to comply with this obligation would allow the Commission to identify and address potential compliance deficiencies or failures (such as inadequate or inaccurate policies and

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counsel) x ($497/hour for outside legal counsel) + (3,773 hours for outside compliance services) x ($273/hour for outside compliance services) = $20.44 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 *infra* Section V.D.

1305 These policies and procedures are in addition to the policies and procedures required under the Conflict of Interest Obligation.

1306 *See supra* Section II.C.4.

procedures, or failure to follow the policies and procedures) early on, reducing the chance of retail customer harm.[1307]

As discussed above in Section III.B.2.d, under the regulatory baseline, broker-dealers are subject to supervisory obligations that, among other things, require them to establish policies and procedures reasonably designed to prevent and detect violations of, and achieve compliance with, the federal securities laws and regulations,[1308] as well as applicable SRO rules.[1309] Broker-dealers would have the ability to update these policies and procedures to comply with the Compliance Obligation, rather than create new policies and procedures.

The obligation indirectly benefits retail customers by ensuring that broker-dealers have sufficient internal controls in place to support compliance with Regulation Best Interest.

The obligation will impose compliance costs on broker-dealers. However, these costs are likely to be smaller for those broker-dealers that already have effective compliance systems in place, including effective policies and procedures.

Broker-dealers may incur operational costs related to training their associated persons and developing policies and procedures to ensure compliance with the Care Obligation. For example, broker-dealers may have to provide training to their employees and other associated persons on how to make recommendations that do not place the interest of the broker-dealer or

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1307 *See supra* Section II.C.4.

1308 *See* Section 15(b)(4)(E) of the Exchange Act.

1309 *See* FINRA Rule 3110 (Supervision).

their associated persons ahead of the interest of the retail customer. In the Proposing Release, these training costs were discussed as part of a separate general best interest obligation, and our assessment of those costs has not changed.[1310] Broker-dealers also may incur costs related to training their associated persons on how to determine that they have a reasonable basis to believe that a recommendation is in a retail customer's best interest. This may include training on how to evaluate the potential risks, rewards, and costs associated with a recommendation as well as how a retail customer's investment profile affects this determination. Additionally, broker-dealers may incur costs related to training their associated persons on any relevant factors specific to making recommendations regarding IRAs, IRA rollovers, or other account types, as well as implicit hold recommendations resulting from agreed-upon account monitoring. These training costs will be lower for broker-dealers that already operate in a manner that is consistent with the requirements of the Care Obligation and higher for those that do not. Firms may already comply with the requirements of the Care Obligation, to varying degrees, either of their own volition or because they are already subject to and comply with similar obligations.

As discussed above, while we are unable to quantify the full costs of Regulation Best Interest, including the Compliance Obligation, we are able to estimate some of the costs associated with the Compliance Obligation, specifically the costs related to information collection requirements as defined by the Paperwork Reduction Act. As discussed further in

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[1310] *See* Proposing Release at Section IV.C.2.a.

Section IV.B.1, the Commission believes that broker-dealers would update their policies and procedures to comply with this requirement. We estimate that broker-dealers would incur an initial aggregate burden of 524,404 hours and an additional initial aggregate cost of approximately $76.3 million, as well as an ongoing aggregate annualized burden of 452,524 hours, and an ongoing aggregate annualized cost of approximately $2.91 million.[1311] Thus, the Compliance Obligation of Regulation Best Interest would impose an initial aggregate cost of at least $214.66 million and an ongoing aggregate annual cost of at least $110.86 million on broker-dealers.[1312]

[1311] These estimates are based on the following calculations: 80,400 hours + 4,536 hours + 11,064 hours + 428,404 hours= 524,404 hours; $6 million + $7.5 million + $62.8 million = $76.3 million; and 24,120 hours + 428,404 hours = 452,524 hours. As discussed in more detail in *infra* Section V.D, 80,400 hours, 4,536 hours, 11,064 hours and 428,404 hours are estimates for the initial aggregate burdens for large and small broker-dealers, updating training module, and training, respectively. In addition, $6 million, $7.5 million, and $62.8 million are estimates for the initial aggregate costs for large and small broker-dealers and updating training modules, respectively. Furthermore, 24,120 hours and 428,404 hours are estimates for the ongoing aggregate burdens for large broker-dealers and training, respectively. Finally, $2.91 million is the estimate of the ongoing aggregate cost for small broker-dealers.

[1312] These estimates are calculated as follows: (65,832 hours of in-house legal counsel) x ($415.72/hour for in-house counsel) + (4,536 hours for in-house compliance counsel) x ($365.39/hour for in-house compliance counsel) + (10,050 hours for reviewing policies and procedures) x ($446.04/hour for in-house general counsel) + (15,582 hours for reviewing policies and procedures and update existing training systems) x ($309.60/hour for in-house compliance manager) + (428,404 hours for training) x ($233.02/hour for registered representative) + (27,163 hours for outside legal counsel) x ($497/hour for outside legal counsel) + (221,127 hours for updating training module) x ($284/hour for outside senior programmer or systems analyst)= $214.66 million, and (8,040 hours of in-house legal counsel) x ($415.72/hour for in-house counsel) + (8,040 hours for in-house

6. Record-Making and Recordkeeping

Regulation Best Interest will also impose record-making and recordkeeping requirements on broker-dealers with respect to certain information collected from, or provided to, retail customers. The Commission is amending Rules 17a-3 and 17a-4 of the Exchange Act, which 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. We are amending Rule 17a-3 by adding a new paragraph (a)(35) that requires 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. This requirement applies to each retail customer to whom a recommendation of any securities transaction or investment strategy involving securities is provided. The neglect, refusal, or inability of a retail customer to provide or update any information about the customer

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compliance counsel) x ($365.39/hour for in-house compliance counsel) + (8,040 hours for updating policies and procedures) x ($229.74/hour for business line personnel) + (8,040 hours for reviewing policies and procedures) x ($309.60/hour for compliance manager) + (3,783 hours for outside legal counsel) x ($497/hour for outside legal counsel) + (3,773 hours for outside compliance services) x ($273/hour for outside compliance services) + (428,404 hours of training) x ($233.02/hour for registered representative) = $110.86 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 *infra* Section V.D.

investment profile will, however, excuse the broker-dealer from obtaining that information. Rule 17a-4(e)(5) will be amended to require that broker-dealers retain all records of the information collected from or provided to each retail customer pursuant to Regulation Best Interest for at least six years after the earlier of the date the account was closed or the date on which the information was last replaced or updated.

The requirement to create certain written records of information collected from or provided to a retail customer under the Disclosure Obligation will trigger a record-making obligation under paragraph (a)(35) of Rule 17a-3 and a recordkeeping obligation under Rule 17a-4(e)(5) that may impose additional compliance costs on broker-dealers. In cases where broker-dealers choose to meet part of the Disclosure Obligation orally under the circumstances outlined above in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*, the requirement to maintain a record of the fact that oral disclosure was provided to the retail customer will trigger a record-making obligation under paragraph (a)(35) of Rule 17a-3 and a recordkeeping obligation under Rule 17a-4(e)(5) that may impose additional compliance costs on broker-dealers. Furthermore, the Care Obligation may require creating new documents or modifying existing documents to reflect standardized questionnaires seeking customer investment profile information. These requirements will also trigger a record-making obligation under paragraph (a)(35) of Rule 17a-3 and a recordkeeping obligation under Rule 17a-4(e)(5) that will impose additional compliance costs on broker-dealers. 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 the

"customer investment profile" that broker-dealers may attempt to obtain to make a customer-specific suitability determination under the Suitability Rule.

As noted above, the Conflict of Interest Obligation requires broker-dealers to establish policies and procedures that are reasonably designed to address conflicts of interest, including disclosing material facts associated with the conflicts. The disclosures will be made pursuant to the Disclosure Obligation and are not expected to trigger record-making or recordkeeping obligations outside the Disclosure Obligation.

The Commission is providing estimates of the initial and ongoing burden hours associated with the record-making and recordkeeping obligations of the Disclosure, Care, and Conflict of Interest Obligations, under certain assumptions. These estimates are discussed in Section IV.B.5. Based on these burden hours estimates, the Commission expects that the record-making and recordkeeping obligations of Regulation Best Interest will impose an initial aggregate burden of 17,684,020 hours and an additional initial aggregate cost of $375,732 as well as an ongoing aggregate annualized burden of 5,520,800 hours on broker-dealers.[1313] After

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[1313] These estimates are based on the Commission's estimates, discussed in Section IV.B.5, with respect to the initial and ongoing aggregate costs and burdens imposed on broker-dealers by the record-making obligation of proposed Rule 17a-3(a)(35) and the recordkeeping obligation of the proposed amendment to Rule 17a-4(e)(5) associated with all component obligations of Regulation Best Interest. The estimate of the initial aggregate burden is based on the following calculation: 4,020 hours + 4,080,000 hours + 13,600,000 hours = 17,684,020 hours, where, as discussed in more detail in Section IV.B.5, 4,020 hours is the estimate of amending the account disclosure agreement by large broker-dealers, 4,080,000 hours is the estimate of the burden associated with filling

monetizing the burden hours, the record-making and recordkeeping obligations will impose an initial aggregate cost of at least $4,121.73 million and an ongoing aggregate annual cost of at least $1,736.52 million on broker-dealers.[1314]

7. Approaches to Quantifying the Potential Benefits

As discussed above, several commenters suggested that we quantify the existing harm to investors under the baseline and the corresponding benefit resulting from Regulation Best Interest. We continue to believe that it is not possible to quantify, with meaningful precision,

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out the information disclosed pursuant to Regulation Best Interest in the account disclosure agreement, and 13,600,000 hours is the estimate of the burden to broker-dealers for adding new documents or modifying existing documents to the broker-dealer's existing retention system. $375,732 is the estimate of amending the account disclosure agreement by small broker-dealers pursuant to the record-making obligation of Rule 17a-3(a)(35). The estimate of the ongoing annual burden is 3,400,00 hours + 1,060,000 hours + 1,060,000 hours = 5,520,800 hours where 3,400,00 hours is the estimate of complying with the recordkeeping obligation of the amendment to Rule 17a-4(e)(5) and 1,060,000 hours are estimates of both the record-making and recordkeeping obligations associated with oral disclosure.

[1314] These estimates are calculated as follows: (2,010 hours of in-house legal counsel) x ($415.72/hour for in-house counsel) + (17,680,000 hours for entering and adding new or modifying existing documents in each customer account) x ($233.02/hour for registered representative) + (2,010 hours for in-house compliance counsel) x ($365.39/hour for in-house compliance counsel) + (756 hours for outside legal counsel) x ($497/hour for outside legal counsel) = $4,121.73 million, and (3,400,000 hours for recordkeeping) x ($365.39/hour for in-house compliance counsel) + (1,060,000 hours for record-making associated with oral disclosure) x ($233.02/hour for registered representative) + (1,060,000 hours for record-keeping associated with oral disclosure) x ($233.02/hour for registered representative) = $1,736.52 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 *infra* Section IV.B.5.

either the existing harm or the specific benefits we expect to flow from Regulation Best Interest. Such an analysis, including one that would produce ranges, depends on many contingent factors that render any estimate insufficiently precise to inform our policy choices.[1315] Nonetheless, the Commission has endeavored to estimate some of the potential benefits that may result from Regulation Best Interest using a variety of methodologies, which are explained below in more detail along with certain caveats and the principal assumptions relied on. Specifically, we have attempted to estimate the benefit that may result from a reduction in fees due to increased competition; we also consider the potential benefit arising from a reduction in the relative performance differences of broker-sold and direct-sold mutual funds.

The quantification exercise below provides an estimate for some of the potential benefits associated with Regulation Best Interest. For example, as discussed in more detail below, a potential reduction in fees can benefit retail customers in other ways beyond reducing the total dollar amount paid for investment services. Furthermore, as discussed elsewhere in this economic analysis, the rule is expected to generate other benefits for retail customers that we are not able to meaningfully quantify.

[1315] *See supra* footnote 1156 and subsequent text for a discussion of these factors. For these reasons and because we believe that quantification of the costs and benefits of the alternatives discussed in *infra* Section III.E would require still further assumptions, lead to additional imprecision, and yield less meaningful results, we have not included quantified estimates of the economic effects of these alternatives.

a. Benefit to Investors Due to a Potential Reduction in Fees

As discussed above, Regulation Best Interest may reduce the attractiveness of certain products to broker-dealers due to the Care Obligation (e.g., the emphasis on the need to consider cost, among other things) and the Conflict of Interest Obligation (e.g., addressing conflicts of interest, including product menu limitations) and/or may reduce retail customers' aggregate demand for certain products due to the Disclosure Obligation (e.g., due to a reduction in any information asymmetry with respect to fees). To the extent that Regulation Best Interest produces these effects on certain products, the affected product sponsors may react by lowering the fees that they charge retail customers on these products to be more competitive, or by repackaging these products into new products that are more competitively priced. The increased competition generated by the lower fees for affected products may further incentivize other product sponsors (i.e., those not directly affected by Regulation Best Interest) to lower their fees as well.[1316] Alternatively, a product sponsor may preempt the potential decline in the aggregate demand for its products by lowering the fees before other sponsors do.

For the purposes of calculation, we assume that this potential competition in prices results in a new long-run equilibrium in this product market, in which product sponsors charge fees that are close to or equal to their marginal costs. Lower fees translate into direct savings to retail

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[1316] A product sponsor that does not lower its fees on a given product may risk experiencing low retail customer aggregate demand or low demand from broker-dealers as a result of Regulation Best Interest. To stay competitive this product sponsor may have to lower the fees on its product.

customers. If a portion of fees collected from retail customers serves to compensate broker-dealers for selling certain investment products, then lowering those fees could also translate into less severe conflicts of interest. Thus, a reduction in fees may improve the efficiency of the recommendations that broker-dealers make to retail customers. This potential increase in the efficiency of the recommendations received also benefits retail customers.[1317]

The market for mutual fund products may illustrate the potential for attaining such a new long-run equilibrium as a result of Regulation Best Interest. We focus on mutual funds for this analysis because of the available data for mutual funds, but we expect the same or similar dynamics could apply to other financial products. As this market transitions toward this new long-run equilibrium, total fund expenses (*i.e.,* distribution expenses and management fees) that are in excess of the marginal cost of distributing and operating the fund may be reduced in a number of ways, including by lowering fees, reliance on alternative distribution channels, or exiting the market in whole or in part (i.e., by limitations on offerings). Below we attempt to quantify the benefits associated with this potential long-run equilibrium in the market for mutual

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[1317] For purposes of this analysis, we assume that product sponsors respond to competitive pressures by lowering their fees. However, competition may affect quality in addition to price. For example, product sponsors may choose to offer higher quality products which may be costlier to produce (e.g., because they must hire more skilled managers or apply more costly technology) and as such require higher fees. Alternatively, product sponsors may lower fees by reducing the quality of their product (e.g., hiring fewer skilled managers) and, as a result, offering lower fee products that may produce lower average returns. Competition along both of these dimensions may allow retail customers to choose different combinations of quality and price, depending on their individual preferences.

fund products as a result of such reduction in fees, relative to the baseline, assuming all funds reduced fees to marginal costs. To this end, we start with the current distribution of fees of funds within each Center for Research in Security Prices (CRSP) objective class.[1318] We focus on funds that have reported this information in 2018 in CRSP. We perform the analysis using total fees (i.e., fund expense ratios). As an alternative, we also perform the analysis using the component of the total fees that are allocated toward distribution and marketing expenses, and that we can observe, namely 12b-1 fees.[1319]

We estimate the marginal cost of distributing and operating a non-index fund in a given CRSP objective class (i.e., strategy) as the minimum total fee of the funds in that class, after excluding index funds. Similarly, we estimate the marginal cost of operating an index fund in a given CRSP objective class as the minimum total fee of the index funds in that class. We then calculate the maximum "excess fee" for a fund (index or non-index) as the difference between

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[1318] Calculated based on data from the Center for Research in Security Prices (CRSP), University of Chicago Booth School of Business. Funds with different objectives may incur different marginal costs due to the frequency of trading in the markets that are reflective of the objective of the fund, advertising to reach a certain clientele, distribution costs, etc. The CRSP Mutual Fund dataset includes a breakdown of mutual funds by their objective types.

[1319] 12b-1 fees are paid out of fund assets to cover the costs of marketing and selling fund shares. "Distribution fees" include fees to compensate brokers and others who sell fund shares, and to pay for advertising and printing and mailing prospectuses to new investors. "Shareholder service fees" are fees that cover the cost of responding to investor inquiries and providing investors with information. This analysis excludes loads because, unlike 12b-1 fees, loads cannot be separately broken out.

the actual total fee of the fund and the marginal cost of the CRSP objective class that contains the fund. By construction, the excess fee cannot be negative.

We obtain an aggregate amount of reduced fees of approximatively $22.2 billion for non-index funds and $1.4 billion for index funds annually at the new potential equilibrium.[1320] The aggregate amount of saved fees across index and non-index funds becomes approximatively $23.6 billion. Similarly, if we focus on 12b-1 fees only, the aggregate amount of saved fees are $9.13 billion for non-index funds and $0.32 billion for index funds, or $9.45 billion across both index and non-index funds.

Using certain assumptions to calculate the present value of this potential fee reduction,[1321] we calculate the net benefit of the new equilibrium as the difference between the

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[1320] We calculate the dollar value associated with these excess fees by multiplying the excess fees of a fund with total net assets (TNA) of the fund and then aggregating across funds. This amount represents the capital that would be reallocated towards more efficient funds and can be thought of as "fees saved" by retail customer as this product market shifts from the baseline equilibrium to the new equilibrium.

[1321] First, we note that expense ratios for equity mutual funds have declined at a rate of about 3% per year since 2000. This rate doubles to 6% if we focus on the period following FINRA's adoption of the Suitability Rule in 2011. We assume that under the current equilibrium, or "baseline equilibrium," excess fees—as defined above—would continue to decline at the rate of 3% per year. This rate of decay corresponds to a half-life of approximatively 23 years. We further assume that as the product market shifts towards the new equilibrium, excess fees decline at a rate that is at least as high as the post-2011 rate. Because Regulation Best Interest enhances the broker-dealer standard of conduct established by the Suitability Rule—particularly with respect to the disclosure, mitigation, or elimination of conflicts of interest, which is not addressed by the Suitability Rule—and the federal securities laws, we believe that a rate of decay that is at least as large as the one observed in the post-2011 period is not unreasonable. Under this assumption, we

two present values of declining perpetuities that pay the dollar value associated with excess fees under the baseline equilibrium and the new equilibrium, respectively, for each of the three scenarios. When using the total fees, we obtain an expected net benefit of $35.21 billion in the moderate decay scenario, $59.15 billion in the accelerated decay scenario, and $76.49 billion in the rapid decay scenario. Similarly, when using 12b-1 fees only, we obtain an expected net benefit of $14.10 billion in moderate decay scenario, $23.69 billion in the accelerated decay scenario, and $30.63 billion in the rapid decay scenario.

b. Benefits to Investors Due to a Potential Reduction in the Relative Underperformance of Broker-versus Direct Sold Mutual Funds

Another way to estimate the potential benefits of Regulation Best Interest is to use aspects of the approach used in the CEA Study and the DOL RIA, as suggested by several commenters.[1322] Specifically, we rely on academic literature claiming that, to varying degrees, broker-sold mutual funds underperform direct-sold mutual funds and assume that underperformance reflects agency costs associated with the conflicts of interest that may be

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consider three scenarios: (1) moderate decay at 6%; (2) accelerated decay at 9%; and (3) rapid decay at 12%. The half-life for each of these scenarios is 11.5 years, 7.7 years, and 5.8 years, respectively. Finally, we assume that the opportunity cost of the excess fees is equal to the expected rate of return on the value-weighted market portfolio, as defined in CRSP, as these fees encumber capital that would have otherwise been invested in efficient funds. To estimate the expected return on the market portfolio, we assume that the discount rate is the geometric average of the annual rate of return on the market portfolio over the period 1927-2018, namely 9.76%.

[1322] *See supra* footnote 1167.

present in recommendations provided by broker-dealers. Although this literature addresses only a portion of the AUM affected by Regulation Best Interest, we use methods from these studies to estimate the monetary effect the final rule might produce by reducing the effect that conflicts of interest have on the recommendations provided by broker-dealers.

Total AUM of load and no-load long-term mutual funds in the U.S. as of the end of 2018 are approximately $12.4 trillion, with $10.4 trillion attributable to no-load funds and $2.1 trillion attributable to load funds.[1323] To estimate the monetary effect of potential conflicts of interest as they pertain to mutual funds, we use estimates of the difference in net returns (gross returns on a fund's performance less fees and other expenses associated with the fund) between broker-sold funds and funds that are direct-sold from Reuter (2015).[1324] We then apply this difference to the aggregate market capitalization of load funds, which we assume are sold with a recommendation from a broker-dealer because we cannot identify the channel through which mutual funds are sold or whether each sale through the broker-sold channel involves a recommendation. To the extent that no-load funds are also sold by broker-dealers, this assumption may cause us to underestimate the portion of mutual fund AUM that are sold with a recommendation from a

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[1323] *See* Investment Company Institute 2019 Fact Book, Figure 6.12.

[1324] *See* Reuter (2015), *supra* footnote 1095. In contrast to the DOL RIA, we do not base our analysis on excess loads, as estimated in Christoffersen et al. (2013), *supra* footnote 1081. Prior commenters noted that the average excess load, by definition, is zero and would likely yield a much lower estimate of aggregate harm, than the estimate published by the CEA and include in the DOL RIA. *See, e.g.*, Lewis (2017), *supra* footnote 1099. *See also supra* footnotes 1169 and 1170.

broker-dealer.[1325] Because the data in Reuter (2015) ends in 2012, for the purposes of this approach we assume that the relative underperformance of broker-sold funds, and hence our application of this underperformance to load funds as a proxy for funds sold with a recommendation from a broker-dealer, remains unchanged from 2012.[1326]

Reuter (2015) employs a variety of methods in computing the difference in net returns between broker-sold and direct-sold actively managed funds, including different ways of computing net returns (e.g., net return, net return plus 12b-1 fees, net alphas, and ordinary least-squares and weighted least-squares regression methods), different samples (e.g. "non-specialized domestic equity"), and different weighting schemes (e.g. equally weighted or value weighted returns). Reuter concludes by noting that the performance difference between broker-sold and direct-sold actively managed mutual funds is likely to fall between 0.20% and 0.47%, depending whether or not 12b-1 fees are included in the estimation. Given that the underperformance only affects broker-sold funds, and applying these underperformance estimates to load funds, the estimated monetized underperformance of broker-sold funds ranges from $4.1 billion per year to $9.7 billion per year.

[1325] Brokers may still be compensated for selling no-load funds by 12b-1 fees, revenue sharing, or other arrangements.

[1326] *See supra* footnote 1102 for discussion of how trends in the relative performance of load funds may have changed in more recent years.

As discussed elsewhere in this release, we expect Regulation Best Interest will reduce the severity of conflicts of interest that may contribute to the underperformance between broker-sold and direct-sold mutual funds. However, the range noted above most likely overestimates the expected reduction in harm associated with broker-sold mutual funds due to Regulation Best Interest for a number of reasons. First, as discussed by Bergstresser et al. (2009), broker-sold funds can be sold by both broker-dealers and investment advisers (e.g., dually registered investment advisers), and the data these studies relied upon is not sufficiently granular to identify the fraction of broker-sold funds sold by each type of financial professional.[1327] Because Regulation Best Interest applies to registered broker-dealers, this range would need to be narrowed to reflect the proportion of broker-sold funds sold by registered broker-dealers.

Second, the estimated range fully attributes the differences between direct-sold funds and broker-sold funds to conflicts of interest between retail customers and broker-dealers. This might over-estimate the benefits of Regulation Best Interest because there might be other unobservable systematic differences between investors who choose direct-sold funds versus those who choose to employ a financial professional. For example, retail customers that buy broker-sold funds might be willing to pay more for those funds if they receive intangible benefits from a broker-dealer's recommendation that are not reflected in the relative performance between funds sold through these two channels. Furthermore, not all sales in the broker-sold

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[1327] *See* Bergstresser et al. (2009), *supra* footnote 1048.

channel are triggered by recommendations provided by broker-dealers or their associated persons. For example, customer-directed transactions may not involve a recommendation at all.

Third, measuring a fund's performance using its net return relative to a benchmark might not be the most accurate measure of a fund manager's skill or the value created by a fund to an investor.[1328] Therefore, estimating investor harm assuming this definition of the value created by a fund might potentially overstate or understate this harm.

Taking into account these caveats,[1329] to the extent that Regulation Best Interest mitigates, and in the limit, eliminates the adverse effects of conflicts of interest on broker-dealers' recommendations, we estimate that the benefits attributable to Regulation Best Interest could be as large as $4.1 billion per year to $9.7 billion per year when estimated assuming that the relative underperformance of broker-sold mutual funds estimated in the academic literature reflects conflicts of interest that will eventually be eliminated.

As with our other estimates of the benefits above, we assume that there is already a decreasing trend in the underperformance gap under the baseline that is consistent with the decreasing trend in mutual fund expense ratios of 3%, and that Regulation Best Interest will accelerate this trend to a decay rate under three scenarios: 1) moderate decay at 6%; 2)

1328 *See supra* footnote 1176.

1329 *See supra* footnotes 1172–1178 for further discussion of the limitations that apply in using the relative underperformance of broker-sold mutual funds as an estimate of investor harm and, therefore, the benefits of Regulation Best Interest.

accelerated decay at 9%; and 3) rapid decay at 12%. Similarly, we assume a discount rate of 9.76% as above to value these cash flows. Under these assumptions, the present value of the potential benefits of Regulation Best Interest in the mutual fund sector, relative to the baseline, from limiting or eliminating the adverse effects of conflicts of interest could be as large as approximately $6.8 to $16 billion in the moderate decay scenario, $11.4 to $26.7 billion in the accelerated decay scenario, and $14.7 to $34.5 billion in the rapid decay scenario.

Finally, we can obtain an approximate estimate of the present value of the costs associated with Regulation Best Interest using the costs estimated in Section IV for purposes of the Paperwork Reduction Act, which imply aggregate initial costs of approximately $5.96 billion and ongoing costs of $2.37 billion. Assuming the initial costs are incurred one year from the rule's enactment, and using a discount rate of 9.76% as above, the present value of these costs is approximately $27.5 billion. Note that this cost estimate cannot be directly compared with the benefit estimates above as the benefits estimates are with respect to mutual funds only.

D. Efficiency, Competition, and Capital Formation

As discussed above, Regulation Best Interest is designed to address the agency costs that arise when an associated person of the broker-dealer provides a recommendation to a retail customer that may not be fully addressed by the regulatory baseline. Regulation Best Interest is intended to reduce agency costs and other costs by enhancing the standard of conduct of broker-dealers, increasing the effectiveness of disclosure to allow retail customers to make a more informed decision with respect to the recommendation they receive and by requiring broker-dealers to implement policies and procedures reasonably designed to reduce the effect of conflicts of interest on recommendations to retail customers. Specifically, the Disclosure Obligation and Conflict of Interest Obligation require broker-dealers to disclose information that,

while not necessarily new in all instances, will reach retail customers more directly and more timely than under the regulatory baseline. In addition, the disclosed information would raise a retail customer's salience of fees, scope of the relationship, conflicts of interest, and limitations of the menu of securities from which the retail customer receives recommendations as potential factors affecting the recommendations of a broker-dealer or its associated persons. The content and form of disclosure may help some retail customers make more informed decisions with regards to whether to act on a recommendation provided by an associated person of the broker-dealer. Regulation Best Interest may also reduce the agency costs faced by these retail customers.

The Conflict of Interest Obligation also requires broker-dealers to implement policies and procedures to reduce the effect of conflicts of interest and securities menu limitations on recommendations to retail customers. For broker-dealers that implement more effective policies and procedures, the obligation may increase the efficiency of the recommendations for their retail customers. As a result, Regulation Best Interest may reduce the agency costs faced by these retail customers.

The Care Obligation requires a broker-dealer and its associated persons to have a reasonable basis to believe that a recommendation provided to a retail customer is in the customer's best interest. This reasonable basis should include factors similar to those identified by the Suitability Rule of the current regulatory regime as well as additional factors. For example, relative to the regulatory baseline, the Care Obligation requires that a broker-dealer and its associated persons consider costs, among other factors, and establish a direct link between the attributes of a security or investment strategy and the retail customer's best interest. By requiring consideration of costs and by including an explicit link between the investment-related factors and the best interest, the obligation may increase the efficiency of the recommendations for the

retail customer. As a result, Regulation Best Interest may reduce the agency costs faced by these retail customers.

Through these effects, as discussed below, Regulation Best Interest may have an effect on competition, capital formation, and efficiency.

1. Competition

Regulation Best Interest may have competitive effects for the market for investment advice and may affect how broker-dealers compete with each for retail customers. As discussed in Section III.C, the brokerage industry currently recognizes that broker-dealers and their associated persons may have conflicts of interest that create incentives for broker-dealers or their associated persons to make recommendations that, while suitable for their retail customers, may not be in the best interest of (and may not be the most efficient recommendations for) such customers. As noted above in Section III.B.2.c, a FINRA survey suggested that broker-dealers currently employ different methods for managing conflicts of interest, with some methods being more effective than others at reducing the effect of conflicts of interest on recommendations. These methods generally depend on the size and complexity of a broker-dealer's business model. Against this backdrop, the cost of complying with Regulation Best Interest, scaled by the size and complexity of a broker-dealer's business activities, may be higher for broker-dealers that currently employ less effective methods for managing conflicts of interest.

Relative to broker-dealers that face lower compliance costs, broker-dealers that face higher compliance costs may be at a disadvantage when competing for retail customers and may not be able to fully pass on these costs to their retail customers. For example, the presumption related to the titles "adviser" and "advisor" may impose higher costs on broker-dealers that use these terms in their names or titles, but that are not dual-registrants.[1330] The extent to which broker-dealers are able to pass on costs to their retail customers depends on a number of factors that include the availability of close substitutes for the services provided by broker-dealers and the cost to retail customers of switching accounts to a competing broker-dealer, investment adviser, or other financial services provider. If broker-dealers are unable to pass costs through to customers, it is possible that some of the broker-dealers that face high compliance costs may decide to exit the market for investment advice in the capacity of a broker-dealer.

The potential competitive effects associated with compliance costs could be further exacerbated by how broker-dealers choose to comply with the component obligations of Regulation Best Interest. As discussed in Section III.C.4, broker-dealers are given flexibility when addressing conflicts of interest through policies and procedures. Because Regulation Best Interest and the component obligations are generally principles-based, a broker-dealer would have to determine what constitutes effective means of addressing a given conflict of interest, and how it should relate to the size and complexity of a broker-dealer's business model. For a broker-

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[1330] *See supra* footnotes 1216-1220.

dealer that is dually registered or for a broker-dealer that is affiliated with an investment adviser, the overall costs of complying with Regulation Best Interest may encourage the broker-dealer to exit the market for providing investment advice in the capacity of a broker-dealer and, instead, provide advice only in the capacity of an investment adviser. Whereas broker-dealers have explicit requirements to establish written policies and procedures reasonably designed to disclose, mitigate or eliminate identified conflicts of interest that create an incentive for the associated persons to place their interest ahead of the retail customer, the fiduciary standard for investment advisers relies on full and fair disclosure and informed consent to address conflicts of interest.[1331] Investment advisers must also adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, including violations related to undisclosed conflicts of interest.[1332] More generally, compliance costs may drive such firms to no longer offer advice in the capacity of a broker-dealer if firms anticipate the profitability of their broker-dealer business under Regulation Best Interest to be lower than the profitability of their advisory business.

[1331] As discussed in *supra* Section I.C, some broker-dealer commenters also expressed the view that by requiring mitigation of financial incentives, Regulation Best Interest would require more of broker-dealers than what is required of investment advisers under their fiduciary duty, which could create a competitive issue for broker-dealers that could further encourage migration from the broker-dealer to investment adviser model and result in a loss of choice for retail customers. Because of this competitive issue, dually registered financial professionals could be incentivized to recommend advisory accounts through compensation.

[1332] *See* Advisers Act Rule 206(4)-7.

Similar concern over costs of complying with Regulation Best Interest may deter some broker-dealers from entering the market for investment advice. Higher entry costs may have long-run competitive effects on prices paid by retail customers, as incumbents adjust their strategic behavior to reflect a lower threat of competition from new entrants, relative to the baseline.[1333] Regulation Best Interest may also encourage competition for retail customers to the extent that the Disclosure Obligation increases the retail customers' salience to variables such as fees and conflicts of interest that would facilitate comparability across broker-dealers. For example, retail customers may form preferences over some or all of the disclosed variables, such as fees, securities or service offerings, and range of conflicts of interest, and may choose one broker-dealer over another or over an investment adviser based on these preferences. In turn, if firms anticipate that there is a possibility that retail customers may use the disclosed variables for comparability purposes, broker-dealers may compete over some or all of these variables to attract more retail customers. This potential competition may result in greater securities or service offerings, or lower fees for retail customers.

Regulation Best Interest may also affect how broker-dealers compete with each other when negotiating with investment sponsors for access to securities. The findings of the aforementioned FINRA survey suggest that broker-dealers may face different degrees of

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[1333] *See, e.g.*, Mas-Colell et al. (1995).

competition when negotiating with product sponsors for access to certain securities. For instance, the survey observed that some product sponsors rate the broker-dealers that are interested in distributing their securities based on criteria such as product expertise and experience, the quality of the control environment, and the strength of their sales practices. Broker-dealers that have higher ratings, based on these criteria may be given access to a broader range of securities, including more complex securities. In contrast, broker-dealers that have lower ratings may be given access to a narrower range of securities. To the extent Regulation Best Interest has the effect of increasing and homogenizing the product expertise and experience (e.g., the Care Obligation) and the quality of the control environment (e.g., the Conflict of Interest Obligation) across the complying broker-dealers, the final rule may increase the competition across firms when negotiating with product sponsors. This increased competition may allow product sponsors to economize on the distribution costs, and may result in lower fees for retail customers.

Regulation Best Interest may also have competitive effects for the market for investment advice, more generally. Regulation Best Interest may affect how broker-dealers compete with firms that provide advice in a capacity other than as a broker-dealer, such as an investment adviser. Under the regulatory baseline, investment advisers owe a fiduciary duty to their clients.

Some commenters describe this standard of conduct as a "higher" standard compared to the standard of conduct applies to broker-dealers under the regulatory baseline.[1334]

For some retail customers the duty owed to them by their firm or financial professional may be a determining factor when deciding which type of firm or financial professional they want to use. As previously noted, key elements of the standard of conduct that applies to broker-dealers, at the time a recommendation is made, under Regulation Best Interest will be substantially similar to key elements of the standard of conduct that applies to investment advisers pursuant to their fiduciary duty under the Advisers Act. As such, the standard of conduct under Regulation Best Interest may make broker-dealers more attractive to certain retail customers who seek recommendations for securities transactions or investment strategies in a more cost effective manner, but worry about the duties owed to them by their financial professional. As a result, Regulation Best Interest may increase the competition between broker-dealers and investment advisers for retail customers interested in obtaining investment advice. In competing for business, broker-dealers and investment advisers may lower their fees, resulting in retail customers paying less for obtaining investment advice. To the extent that this potential lower cost causes an increase in the demand for investment advice in the capacity of a broker-dealer, this positive competitive effect may offset some of the negative potential competitive

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1334 *See* Letter from Ken Fisher, Fisher Investments (Jul. 31, 2018) ("Fisher Letter"); PIABA Letter; FPC Letter; NASAA August 2018 Letter; U. of Miami Letter; Rhoades August 2018 Letter.

effects of Regulation Best Interest, such as higher cost of entry in the market for investment advice in the capacity of a broker-dealer relative to the baseline, as discussed above.

The Disclosure Obligation may also encourage competition for retail customers across broker-dealers and investment advisers. As noted above, the Disclosure Obligation would require broker-dealers to make 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 a recommendation. Investment advisers are also required to provide full and fair disclosure of material facts about similar elements under the current regulatory regime. To the extent that the Disclosure Obligation raises the salience of variables that may facilitate comparison across broker-dealers and investment advisers, Regulation Best Interest may encourage competition between broker-dealers and investment advisers.

Regulation Best Interest may also have competitive effects for financial professionals that offer investment advice in a capacity other than that of a broker-dealer (e.g., investment advisers and other financial professionals that are not registered with the Commission, such as insurance companies, banks, and trust companies). As discussed above in Section III.C.4, depending on the effectiveness of disclosure and the effectiveness of policies and procedures that address securities menu limitations (e.g., the Disclosure Obligation and Conflict of Interest Obligation), Regulation Best Interest may reduce the retail customers' aggregate demand for certain securities that are distributed by broker-dealers and securities on which broker-dealers or their associated persons provide recommendations. Instead, retail customers may access some of these or comparable securities from other financial professionals. For example, a retail customer may access certain securities offered by broker-dealers through corporate fiduciaries such as commercial banks or trust companies. Alternatively, a retail customer may open an advisory

account and access securities that are comparable to those offered by the broker-dealer. To the extent that Regulation Best Interest causes a potential reduction in the retail customers' aggregate demand for securities offered by broker-dealers, retail customers' aggregate demand may increase for securities offered by non-broker-dealers. Regulation Best Interest may also affect how product sponsors compete for flows from retail customers. As discussed above in Section III.C.4, depending on the effectiveness of disclosure and the effectiveness of policies and procedures that address limitations of the menu of securities (e.g., Disclosure and Conflict of Interest Obligations), Regulation Best Interest may reduce the aggregate demand for certain sponsors' securities. To remain competitive, product sponsors that face decreased demand as a result of Regulation Best Interest may reprice their securities (e.g., by offering different share classes), lower their fees, or seek alternative distribution channels that are not affected by Regulation Best Interest. For example, product sponsors may choose to distribute their securities through investment advisers or through commercial banks to the extent that the banks can engage in limited broker-dealer activity, subject to certain conditions, without having to register as broker-dealers.[1335] Finally, product sponsors may choose to distribute their securities directly to retail investors rather than indirectly, through broker-dealers. The potential competitive effect of

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[1335] *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).

Regulation Best Interest on product sponsors may manifest itself in lower product fees for retail customers.

2. Capital Formation and Efficiency

Regulation Best Interest is designed to reduce the agency and other costs to retail customers associated with obtaining recommendations from broker-dealers. As discussed above, to reduce these costs, Regulation Best Interest would impose obligations on broker-dealers that are designed to increase the efficiency of the recommendations to retail customers relative to the recommendations that broker-dealers and their associated persons provide to retail customers under the regulatory baseline.

To the extent retail customers receive recommendations that are more efficient relative to the baseline, Regulation Best Interest would increase the efficiency of the portfolio allocation that a retail customer makes as a result of the recommendation received. As discussed above in Sections III.A.2 and III.C, this would occur when a retail customer increases the allocative efficiency of his or her portfolio when the recommendation leads to a reallocation of resources across time and market and economic conditions that generate a higher net benefit to the retail customer, relative to the baseline. Thus, to the extent that Regulation Best Interest increases the efficiency of the associated persons' recommendations to retail customers, the final rule would have a positive effect on the retail customers' allocative efficiency.

Regulation Best Interest may also increase the efficiency of the recommendations involving rollovers or transfers of assets from retirement accounts to other taxable or non-taxable accounts, relative to the baseline. As noted above, the incentives associated with this type of recommendation are particularly acute because of the size of the transaction and the importance to the retail customer (e.g., given that the amount of assets associated with such

recommendations can be a significant portion of a retail customer's net worth). The potential increase in the efficiency of this type of recommendation may improve the allocative efficiency of assets held in retirement accounts, and may encourage retail customers to consider a rollover or transfer of assets recommendation to potentially increase the efficiency of their retirement asset allocation.

Similarly, Regulation Best Interest may increase the efficiency of the recommendations regarding account types. As discussed above, currently, a dual-registrant may have an incentive to recommend the account type that benefits the dual-registrant at the expense of the retail customer. The potential increase in the efficiency of this type of recommendation under Regulation Best Interest relative to a similar recommendation that the dual-registrant may provide under the baseline may improve the allocative efficiency of the retail customer's assets held in this account.

The possibility that Regulation Best Interest may increase the efficiency of the recommendations provided by the associated persons of the broker-dealer may enhance the attractiveness of broker-dealer services for those investors who currently do not invest through broker-dealers. Although there are costs associated with these requirements, the protections deriving from these requirements may benefit investors, issuers, and intermediaries by helping to create a marketplace where a higher number of retail customers invest through broker-dealers, relative to the current regulatory regime. If retail customers are more willing to participate in the securities markets through broker-dealers, Regulation Best Interest would have a positive effect on capital formation.

E. Reasonable Alternatives

Regulation Best Interest establishes a new standard of conduct for broker-dealers under the Exchange Act that is intended to address the agency costs that retail customers face when obtaining recommendations of securities transactions and investment strategies from broker-dealers and their associated persons. This new standard is intended to enhance investor protection, while preserving, to the extent possible, retail investor access (in terms of choice and cost) to differing types of investment services and securities. As noted above, the Commission considered several reasonable alternative policy choices, including (1) applying the fiduciary standard under the Advisers Act to broker-dealers, and (2) adopting a "new" uniform fiduciary standard of conduct applicable to both broker-dealers and investment advisers, such as that recommended by the staff in the 913 Study. The Commission also considered adopting similar standards to those the DOL had provided under its fiduciary rule to broker-dealers and investment advisers.[1336] We examine the effects of these primary alternatives, as well as several other alternatives that we considered both in the Proposing Release and in response to comments.

[1336] We had additionally discussed in the Proposing Release an alternative of a principles-based best interest standard. *See* Proposing Release at 21663. Some of the economic effects of this alternative would be similar to the economic effects of any of the fiduciary alternatives, which would also be principles-based.

1. Fiduciary Standard for Broker-Dealers

As discussed in the Proposing Release and as raised by commenters, instead of adopting our approach in Regulation Best Interest, the Commission could have alternatively imposed a form of fiduciary standard on broker-dealers providing recommendations to retail customers. The Commission recognized that fiduciary standards vary among investment advisers, banks acting as trustees or fiduciaries, or ERISA plan providers, but fiduciaries are generally required to act in the best interest of their clients.[1337]

Under any of the options considered, the Commission would have to craft a mechanism to apply a uniform standard of conduct to all financial professionals regardless of how they engage with their retail customers. This approach was advocated by certain commenters, many of whom asserted that it would reduce retail investor confusion as it would ensure that investors are provided the same standard of care and loyalty regardless of what type of financial professional they engage.[1338] As discussed above and in detail further below we believe, in practice, that such uniformity would be difficult to implement and disruptive to pursue as a result of various factors, including the key differences in the ways broker-dealers and investment

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1337 *See* Proposing Release at footnotes 328-329. For example, an investment adviser's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty. This combination of care and loyalty obligations has been characterized as requiring the investment adviser to act in the "best interest" of its client at all times. *See* Fiduciary Interpretation.

1338 *See, e.g.*, Better Markets Letter at 24.

advisers engage with retail clients. Achieving such uniformity could require narrowing the type and scope of services permitted to be provided by various types of financial professionals. If we were to pursue such an approach, it could reduce retail customers' confusion with respect to the duties owed to them by the broker-dealers and investment advisers and could reduce potential costs to some investors associated with choosing a type of relationship that is not well suited to them, because under a uniform standard, retail customers of each type of financial professional would be subject to the same standard of conduct.

However, this uniformity could come at a cost to both investors and financial service providers. Such an approach could result in a standard of conduct for broker-dealers that is not appropriately tailored to the structure and characteristics of the broker-dealer model (i.e., transaction specific recommendations and compensation), and might not properly take into account, or build upon, existing obligations that apply to broker-dealers, including under FINRA rules.[1339] A potential implication of this paradigm shift would be that broker-dealers would face significant compliance costs, at least in the short run, relative to the regulatory baseline. Potentially higher compliance costs could increase the incentive to offer investment advice in the capacity of investment adviser and could decrease the incentive to offer investment advice in the capacity of broker-dealer. To the extent broker-dealers act on the increased incentives and decide to participate in the market for investment advice only in the capacity of investment advisers,

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[1339] *See also* 913 Study at 139-143.

retail customers could experience an increase in the cost of obtaining investment advice, relative to the baseline. Furthermore, as noted above, the potential exit of broker-dealers from the market for investment advice in the broker-dealer capacity could limit how retail customers would access certain securities or investment strategies and how they would pay for investment advice, which, in turn, could increase their costs of obtaining investment advice, relative to the baseline.[1340] To the extent broker-dealers decide to continue to participate in the market for investment advice in the capacity of broker-dealers, they could pass on increased compliance costs, in full or in part, to their retail customers. As a result, retail customers could experience an increase in the cost of obtaining investment advice, relative to the baseline. The potential increase in the cost of accessing investment advice could push some retail customers outside the market for investment advice from Commission-registered broker-dealers and investment advisers.[1341]

We discuss each of the three options for applying a uniform fiduciary standard in more detail below. We compare each of the three alternatives against the regulatory baseline, which is the current broker-dealer regulatory regime. In addition, we briefly discuss the differences between the standard of conduct imposed by Regulation Best Interest and the fiduciary standard under the Advisers Act. As discussed above in Section I, we believe that our approach in

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1340 *See supra* Section III.D.1.

1341 *See supra* Section I.A for a discussion of access to investment advice in the context of the DOL Fiduciary Rule.

adopting Regulation Best Interest will best achieve the Commission's important goals of enhancing retail investor protection and decision making, while preserving, to the extent possible, retail investor access (in terms of choice and cost) to differing types of investment services and securities.

a. Fiduciary Standard under the Advisers Act Applied to Broker-Dealers

A number of commenters discussed the viability of this alternative and stated that it would provide superior investor protection benefits relative to the standard that the Commission proposed.[1342] At the outset, we note that, at the time a recommendation is made, key elements of the standard of conduct that applies to broker-dealers under Regulation Best Interest will be substantially similar to key elements of the standard of conduct that applies to investment advisers pursuant to their fiduciary duty under the Advisers Act. Both standards of conduct require that, when making a recommendation or providing advice, firms and financial professionals act in the best interest of the retail investor and not place the financial professionals' interests ahead of the retail investor.[1343] Both standards provide methods for addressing conflicts

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1342 *See* Betterment Letter; Warren Letter; Fein Letter; State Treasurers Letter; AARP August 2018 Letter; ACLI Letter; Schwab Letter.

1343 *See supra* Section I.A.

of interest, although the mechanics of those methods and their outcomes may be different,[1344] and both standards require full and fair disclosure of material facts that affect the relationship, including costs. Both standards allow each type of financial professional to agree to provide account monitoring services to retail investor accounts, although continuous monitoring is embedded in the regulatory regime and market practices for investment advisers, whereas a broker-dealer may agree to provide account monitoring services only to the extent that it is solely incidental to the primary brokerage business.[1345]

We recognize that there are certain notable differences between the Advisers Act fiduciary standard and the Regulation Best Interest standard we are adopting. In particular, the investment adviser fiduciary duty is generally principles-based, in keeping with the regulatory tradition and market practices for advisers,[1346] whereas Regulation Best Interest, while also largely principles-based, establishes minimum, obligations that are generally more prescriptive than the fiduciary obligations under Advisers Act. Further, advisers are able to address conflicts

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1344 Whereas, pursuant to Regulation Best Interest, broker-dealers are required to (i) to establish written policies and procedures reasonably designed to identify and at a minimum, disclose, or eliminate, all conflicts of interest; and (ii) to establish written policies and procedures reasonably designed to mitigate or eliminate identified conflicts of interest, the fiduciary standard for investment adviser relies on full and fair disclosure and informed consent.

1345 *See* Solely Incidental Interpretation. *See also supra* Section II.B.2.b.

1346 *See* Fiduciary Interpretation.

of interest through full and fair disclosure and informed consent,[1347] while broker-dealers must have policies and procedures that are reasonably designed to identify and disclose and mitigate, or eliminate, any conflicts of interest associated with recommendations that create an incentive for the broker-dealer or its associated persons to place the interest of the broker-dealer or its associated persons ahead of the interest of the retail customer. With regard to the substance of both standards, the investment adviser fiduciary duty generally is broader and applies to the entire relationship between adviser and client, including providing non-securities advice,[1348] whereas Regulation Best Interest only applies at the time of a recommendation of any securities transaction or investment strategy by a broker-dealer to its retail customers.[1349] Where application of the Advisers Act fiduciary standard to broker-dealers would impose on broker-dealers obligations similar to those of Regulation Best Interest, we anticipate similar economic

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1347 *See id.*

1348 For example, an investment adviser may consider both securities annuity products (e.g., variable annuities) and non-securities annuity products (*e.g.*, fixed annuities) when providing advice on annuity products to a client with an advisory retirement account.

1349 However, under the current legal and regulatory regime, broker-dealers are subject to other rules that apply outside the context of a recommendation, including rules regarding how broker-dealers market securities and services (communications with the public), how they execute trades (best execution), and the fees that they charge (fair and reasonable compensation obligations). Moreover, broker-dealers always a have a duty of fair dealing with their retail customers under SRO rules. In addition, broker-dealers are subject to 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, including requirements to eliminate, mitigate, or disclose certain conflicts of interest. *See* Proposing Release Section I.A.1.

effects; in contrast, where this alternative would result in different obligations, it would generate economic effects distinct from those of Regulation Best Interest.

i. Fiduciary Standard under the Advisers Act Relative to the Baseline

Relative to the regulatory baseline, the fiduciary standard of this alternative applied to broker-dealers could benefit retail customers in some circumstances by extending the obligations of all firms and financial professionals to act in the best interest of retail customers (and to not place the interest of the firm or the interest of the financial professionals ahead of those of the retail customers) to aspects of the relationship other than providing personalized investment advice through recommendations. For example, retail customers might benefit if broker-dealers were required (as advisers are under their current fiduciary standard) to disclose any material conflicts related to their execution of trades for retail customers in the case when the broker-dealer has not provided a recommendation regarding the transaction (e.g., self-directed trade). In addition, under the fiduciary standard that applies to investment advisers, if an investment adviser cannot fully and fairly disclose a material conflict of interest to a client such that the client could reasonably be expected to provide informed consent, the investment adviser would be expected to either eliminate the conflict or adequately mitigate (i.e., modify its practices to reduce) the conflict to the point where full and fair disclosure of the conflict to the client and informed consent is possible.[1350] To the extent that this approach of addressing conflicts of

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[1350] *See* Fiduciary Interpretation.

interest would extend to the fiduciary standard in this alternative, a broker-dealer would also have to eliminate or modify a conflict of interest to the point where full and fair disclosure and informed consent is possible. The potential reduction in the effect of conflicts of interest on recommendations and the potential reduction in the information asymmetry between a retail customer and a broker-dealer would likely increase the efficiency of the recommendation provided by the firm to the retail customer, relative to the baseline. Thus, this alternative may reduce the agency costs of the relationship between a broker-dealer and a retail customer, which would benefit retail customers, relative to the baseline.

However, any such benefits would come at a cost. As an initial matter, the fiduciary standard under this alternative is a principles-based regime and shaped by decades of case law specific to investment advisory model. In contrast, the standard of conduct that applies to broker-dealers under the baseline is more prescriptive, and governed by detailed SRO rules. Therefore, if this alternative were adopted, broker-dealers would face increased compliance costs resulting from having to conform their advice models to a regulatory regime that was not formed for a transaction-based model governed by detailed SRO rules.

The potential increased compliance costs associated with applying the fiduciary standard in this alternative to broker-dealers would likely increase the broker-dealers' incentives to offer investment advice in the capacity of investment adviser and may decrease their incentive to continue offering investment advice in the capacity of broker-dealer dealer (on a transaction-by-

transaction basis), relative to the baseline.[1351] For example, if this alternative were to create situations where the compensation to a broker-dealer for providing a recommendation in a commission-based brokerage account would be less than the compensation under a fee-based

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[1351] *See* Vivek Bhattacharya, Gaston Illanes, & Manisha Padi, *Fiduciary Duty and the Market for Financial Advice* (Working Paper, Apr. 2019) for a recent paper providing an empirical analysis on the effect of state-level standards of conduct on the structure of the market for investment advice in the context of variable annuities. The study finds differences in broker-dealer behavior when comparing states with and without a fiduciary obligation for broker-dealers. The states with the obligation are associated with fewer variable annuity sales and are also associated with some broker-dealers exiting the industry. Specifically, the paper observes, among other things, that a state-level obligation reduces the number of broker-dealers that are not dually registered by about 16% but has no meaningful effect on the number of dual-registrants. The authors argue that this compositional shift in the number of broker-dealers is due to firms exiting the market. The paper also observes that a state-level obligation on broker-dealers may cause a compositional shift in the pool of variable annuities sold by broker-dealers toward annuities that offer a larger and more diverse set of investment options, which, in certain circumstances, may also generate higher expected returns for retail customers. The paper also observes that under certain circumstances a state-level obligation on broker-dealers may increase the quality of the variable annuities sold by broker-dealers. "Quality" is defined by the authors as "the return on variable annuities assuming optimal allocation." The authors interpret these results as suggesting that a state-level obligation on broker-dealers may (i) cause some broker-dealers to exit the market, and (ii) cause a compositional shift in the variable annuities sold by the broker-dealers that do not exit the market toward annuities of higher quality as defined in the paper. However, the limitations of the data sample and of the empirical methodology make it difficult to (i) generalize these results to the entire market of annuities sold by broker-dealers, (ii) extrapolate these results to the entire universe of securities that broker-dealers offer advice on, (iii) extrapolate the results to the population of broker-dealers not captured by the data sample, or (iv) use the results as a basis for comparing the investor protections offered by state-level standards of conduct, SRO rules, existing federal standards of conduct, and Regulation Best Interest. *See also supra* footnote 1163 and surrounding discussion noting that there is substantial variation in the sources, scope, and application of state fiduciary law.

advisory account and/or where the perceived regulatory burden for an investment adviser is lower, relative to the baseline, a broker-dealer's incentive to offer advice in the capacity of investment adviser would likely increase, relative to the baseline.[1352]

To the extent broker-dealers act on the increased incentives and decide to participate in the market for investment advice only in the capacity of investment advisers—for example, dual-registrants may prefer to offer investment advice only in the capacity of investment adviser—retail customers may experience an increase in the cost of obtaining investment advice, relative to the baseline. Furthermore, as noted above, the potential exit of broker-dealers from the market for investment advice in the capacity of broker-dealer may limit how retail customers can access certain securities or investment strategies and how they can pay for investment advice, which, in turn, may further increase the cost of obtaining investment advice, relative to the baseline.[1353] Alternatively, to the extent broker-dealers decide to continue to participate in the market for investment advice in the capacity of broker-dealers, they may pass on the increased compliance costs, in full or in part, to their retail customers in the form of higher prices for services rendered. In particular, retail customers may experience an increase in the cost of obtaining investment advice, relative to the baseline.

[1352] Broker-dealers that choose to deregister would eliminate the costs of complying with FINRA rules, which are broader than retail customer sales practice obligations, and submitting to FINRA examinations as well as compliance with other specific rules, which do not apply to advisers.

[1353] *See supra* Section III.D.1.

It is also possible that the fiduciary standard of this alternative may result in a different menu of choices that allows retail customers to access investment advice in a more cost-efficient manner relative to the baseline. For example, if more financial professionals decide to participate in the market for investment advice in the capacity of investment advisers, competitive pressure may result in investment advisers providing better pricing and/or more choices of accessing investment advice for retail customers.

To the extent that the cost of accessing investment advice increases under the fiduciary standard of this alternative, some retail customers may be pushed outside the market for investment advice. For example, currently, a retail customer that prefers to receive recommendations from a broker-dealer or its associated persons to implement a buy-and-hold strategy may find a brokerage account to be better suited to his or her needs compared to an advisory account.[1354] Under the fiduciary standard in this alternative, this retail customer may

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[1354] For example, Del Guercio & Reuter (2014), *supra* footnote 1081, document (Table 1 on page 1682) that retail customers can access index funds through both broker-dealers (i.e., the broker-sold channel, as discussed above) and directly from the fund sponsor (i.e., the direct-sold channel). Furthermore, in their sample, the average expense ratio for an index fund is 0.86 if sold through the broker-sold channel and 0.44 if sold through the direct channel. Assuming that a retail customer is interested in implementing a buy-and-hold strategy using index funds that carry no loads, the cost to the retail customer of implementing this strategy through a broker-dealer would be on average 86 basis points of the assets invested per year. In contrast, the cost to the retail customer of implementing the same strategy through an investment adviser would be on average 44 basis points plus the investment adviser's AUM-based fee per year. Assuming that in the investment adviser's fee is 100 basis points of AUM per year, the cost to the retail customer of

have to pay more for the broker-dealer services that come with his or her account, including obtaining investment advice, relative to the baseline. If this increase in the cost for broker-dealer services outweighs the benefits of the potential improved efficiency of the recommendations provided by the broker-dealer for this retail customer, as noted above, the retail customer may prefer to switch to a more-limited brokerage account that does not come with personalized investment advice (e.g., an execution-only brokerage account).[1355] Alternatively, and as noted by one commenter, the retail customer may switch to a light version of an advisory account that implements automated investment strategies tailored around a retail customer's goals.[1356] However, this type of advisory account may not offer the flexibility of personalized investment advice to the evolving needs of the customer and may not be as responsive to market movements not anticipated by the automated investment strategies.

b. Uniform Fiduciary Standard under 913(g)

Another alternative approach to the standard of conduct imposed by Regulation Best interest is a "new" uniform fiduciary standard of conduct applicable to both broker-dealers and

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implementing his or her strategy with an investment adviser would be on average 144 basis points.

1355 Relative to a brokerage account that offers personalized investment advice, execution-only brokerage accounts may also come with enhanced research tools, more investment choices, and, potentially, other forms of impersonal advice.

1356 *See, e.g.*, CFA August 2018 Letter at 79, noting that "[f]or example, Vanguard charges 0.30% for its Personal Advisor Services, Schwab charges 0.28% for its Intelligent Advisory Services, and Betterment charges 0.25% for its Digital offering and 0.40% for its Premium offering."

investment advisers, such as that recommended by the staff in the 913 Study.[1357] The fiduciary standard under this alternative 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." Based on the Commission staff's recommendations about ways in which the fiduciary standard proposed by the 913 study could be implemented, the fiduciary standard under this alternative could have imposed any or all of the following requirements: (1) eliminate or disclose conflicts of interest; (2) prohibit certain conflicts of interest by requiring firms to mitigate conflicts through specific action, or to impose specific disclosure and consent requirements; and (3) specify the basis a broker-dealer or investment adviser has in making a recommendation to a retail customer by referring to and expanding upon broker-dealers' existing suitability requirements.

[1357] 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." 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. *See* 913 Study.

Some of the benefits of the investment advisers' fiduciary standard of the previous alternative would carry over to the new uniform standard of this alternative. In particular, relative to the baseline, the new fiduciary standard of this alternative applied to broker-dealers could benefit retail customers in some circumstances by extending the obligations of all firms and financial professionals to act in the best interest of retail customers (and to not place the interest of the firm or those of the financial professionals ahead of the interest of the retail customer) to aspects of the relationship other than providing personalized investment advice through recommendations.

In addition, the new fiduciary standard of this alternative applied to broker-dealers may create additional benefits for their retail customers, relative to the baseline. For example, requirements (1) and (2) may enhance the obligations under the baseline by requiring broker-dealers to disclose conflicts of interest and to take actions to mitigate or eliminate certain conflicts of interest. To the extent that these requirements reduce of the effect of the conflicts of interest on the recommendation provided by a broker-dealer or its associated persons and reduce the information asymmetry between retail customers and broker-dealers, the new fiduciary standard of this alternative may increase, relative to the baseline, the efficiency of the recommendations made by broker-dealers and their associated persons. Furthermore, requirement (3) may enhance the existing suitability requirements that apply to broker-dealers and, to the extent that this requirement results in recommendations that are better aligned with the objectives of the retail customers, the new fiduciary standard of conduct of this alternative may further increase, relative to the baseline, the efficiency of the recommendations provided by broker-dealers and their associated persons. The potential increase in the efficiency of the

recommendations provided by broker-dealers and their associated persons under the new fiduciary standard of this alternative would benefit retail customers, relative to the baseline.

Similarly, the new fiduciary standard of this alternative applied to investment advisers may create benefits for their clients, relative to the baseline. Requirements (1) and (2) would enhance the obligations of the investment advisers under the current fiduciary standard that applies to investment advisers by requiring investment advisers to take actions to mitigate or eliminate certain conflicts of interest. To the extent that these requirements reduce of the effect of the conflicts of interest on the recommendation provided by an investment adviser or its associated persons and reduce the information asymmetry between retail customers and investment advisers, the new fiduciary standard under this alternative may increase the efficiency of the recommendations made by investment advisers and their associated persons, relative to the baseline.

The new fiduciary duty of this alternative may also result in increased competition across financial professionals for retail customers or clients, relative to the baseline. This potential increase in competition, relative to the baseline, may benefit retail customers of broker-dealers and clients of investment advisers in the form of lower prices for investment advice.

Turning to the potential costs imposed by this alternative, we note that some of the costs of the investment advisers' fiduciary standard of the previous alternative carry over to the new fiduciary standard of this alternative. As noted above, this alternative would impose a new regulatory paradigm on broker-dealers relative to the baseline. The fiduciary standard of this alternative would be principles-based and shaped by common law. In contrast, the standard of conduct that applies to broker-dealers under the baseline is more prescriptive and governed by detailed SRO rules. A paradigm shift from the standards of conduct under the current baseline to

the uniform standard in this alternative may increase compliance costs relative to the baseline.[1358]

Furthermore, the potential increased compliance costs associated with applying the fiduciary standard of this alternative to broker-dealers may increase, relative to the baseline, a broker-dealer's incentives to offer investment advice in the capacity of an investment adviser and may decrease their incentive to offer investment advice in the capacity of broker-dealer. For example, if this alternative creates situations where the compensation to a broker-dealer for providing a recommendation in a commission-based brokerage account would be less than the compensation under a fee-based advisory account while the perceived regulatory burden is equal to that of an investment adviser, a broker-dealer's incentive to offer advice in the capacity of investment adviser may increase, relative to the baseline.[1359]

To the extent broker-dealers act on the increased incentives and decide to participate in the market for investment advice only in the capacity of investment advisers—for example, dual-registrants may prefer to offer investment advice only in the capacity of investment adviser—retail customers may experience an increase in the cost of obtaining investment advice, relative to the baseline. Alternatively, to the extent broker-dealers decide to continue to participate in the market for investment advice in the capacity of broker-dealers, they may pass on the increased

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[1358] *See also* 913 Study at 156-159.

[1359] *See supra* footnote 1352.

compliance costs, in full or in part, to their retail customers in the form of higher prices for services rendered, relative to the baseline. In particular, retail customers may experience an increase in the cost of obtaining investment advice, relative to the baseline.[1360]

Similarly, the new fiduciary standard of this alternative may also impose additional compliance costs for investment advisers relative to the baseline.[1361] For example, to the extent that investment advisers currently provide investment advice to their clients in a manner that is not fully consistent with the requirements (2) and (3), investment advisers may incur compliance costs in adhering to these potentially more stringent requirements.

Investment advisers would likely pass on the potential increase in the costs of complying with the new fiduciary standard of this alternative to their clients. In turn, under the new fiduciary standard of this alternative, clients may experience an increase in the cost of obtaining investment advice, relative to the baseline.

It is also possible that the new fiduciary standard of this alternative may result in a different menu of choices that allows retail customers and clients to access investment advice in a more cost-efficient manner relative to the baseline. For example, if more financial professionals decide to participate in the market for investment advice as investment advisers,

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1360 *See also* 913 Study at 159-162.

1361 *See id.* at 159.

competitive pressure may result in better pricing and/or greater choice in accessing investment advice for retail customers and clients that choose to use an investment adviser.

However, to the extent that the cost of accessing investment advice increases under the new fiduciary standard of this alternative, some retail customers may be pushed outside the market for investment advice, relative to the baseline. For example, currently, a retail customer who prefers to receive recommendations from a broker-dealer or its associated persons to implement a buy-and-hold strategy may find a brokerage account to be better suited to his or her needs than an advisory account. Under the new fiduciary standard of this alternative, this retail customer may have to pay more for the broker-dealer services that come with his or her account, including obtaining investment advice, relative to the baseline. If, from the perspective of a retail customer, this increase in the cost for broker-dealer services outweighs the expected benefits of the potential improved efficiency of the recommendations provided by the broker-dealer, the retail customer may prefer to switch to a more limited brokerage account that does not come with personalized investment advice (e.g., an execution-only brokerage account).[1362]

Alternatively, and as noted by one commenter, the retail customer may switch to an advisory account that implements automated investment strategies.[1363] However, this type of

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[1362] Relative to a brokerage account that offers personalized investment advice, execution-only brokerage accounts may also come with enhanced research tools, more investment choices, and, potentially, other forms of impersonal advice.

[1363] *See, e.g.*, CFA August 2018 Letter at 79, noting that "[f]or example, Vanguard charges 0.30% for its Personal Advisor Services, Schwab charges 0.28% for its Intelligent

advisory account may not offer the flexibility of personalized investment advice to the evolving needs of the customer, the level of contact a retail customer seeks from a relationship with a financial professional, and may not be as responsive to market movements not anticipated by the automated investment strategies.

Similarly, under the new fiduciary standard of this alternative, clients of investment advisers may experience an increase in the cost of obtaining investment advice. Some of these clients may not be able to afford the additional cost and may be pushed outside the market for investment advice, relative to the baseline. As noted above, the options available to these clients may not offer the flexibility of tailored investment advice that may benefit a client with evolving needs.

c. Fiduciary Standard under the DOL Rule and BIC Exemption

A third alternative approach to addressing the agency costs associated with obtaining advice from broker-dealers is a fiduciary standard coupled with a series of disclosures and other requirements akin to the full complement of conditions of the DOL's BIC Exemption adopted in connection with the DOL Fiduciary Rule. This alternative would mirror the key conditions that apply to an "adviser" under the BIC Exemption.[1364] This alternative approach would apply to

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Advisory Services, and Betterment charges 0.25% for its Digital offering and 0.40% for its Premium offering."

[1364] For a discussion of key conditions of the BIC Exemption, *see* Section I.A.2 of the Proposing Release at 21581. As discussed above, the DOL Fiduciary Rule—including the BIC Exemption—was vacated by the United States Court of Appeals for the Fifth Circuit

broker-dealers when providing recommendations to retail customer for all types of retail accounts rather than retirement accounts only. At least one commenter signaled support for this alternative.[1365]

Unlike other alternatives considered in this section, or Regulation Best Interest, this alternative can be analyzed, at least in part, based upon its previous adoption by the DOL and partial implementation. Because this alternative was already partly implemented, the market for investment advice, the securities market, and, ultimately investors have had an opportunity to partially adjust to it. Section III.B.2.e.ii summarizes the evidence about the response of firms, investors and product markets in response to the DOL Fiduciary Rule.

The requirements of the standard of conduct in this alternative would enhance the obligations under the baseline by requiring broker-dealers to adhere to the impartial conduct standard, which included requirements to act in their retail customers' best interest, disclose material conflicts of interest and designate a person responsible for addressing material conflicts of interest and monitoring the adherence of the associated persons of the broker-dealer to the impartial conduct standard. To the extent that these requirements reduce the effect of the conflicts of interest on the recommendation provided by a broker-dealer or its associated persons

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on March 15, 2018, although some firms may continue to seek comply with certain of its conditions under a DOL temporary enforcement policy. *See also supra* Section III.B.2.e. *See also supra* footnote 32.

1365 *See* Galvin Letter.

and reduce the information asymmetry between retail customers and broker-dealers, the new standard of conduct in this alternative would increase the efficiency of the recommendations made by broker-dealers and their associated persons, relative to the regulatory baseline. Furthermore, the requirement to act in the retail customers' best interest would enhance the existing suitability standard that applies to broker-dealers and, to the extent that the new standard of conduct of this alternative would result in recommendations that are better aligned with the objectives of the retail customers, this new standard would further increase the efficiency of the recommendations provided by broker-dealers and their associated persons, relative to the regulatory baseline. The potential increase in the efficiency of the recommendations provided by broker-dealers and their associated persons under the new standard in this alternative would benefit retail customers, relative to the baseline.

This alternative may also affect product markets. As discussed above in Section III.B.2.ii, certain product sponsors introduced new products in the market for mutual funds, such as clean and T shares that were designed to facilitate compliance with various anticipated regulations, including the DOL Fiduciary Rule. In certain circumstances, these products may come with lower fees for retail customers. To the extent that this alternative would enhance this trend in product innovation, retail customers may benefit from this trend.

However this alternative would also impose costs on broker-dealers and retail customers. Compliance costs would include costs associated with the contract provision, and the disclosure, policies and procedure, and record-making and recordkeeping requirements. It is possible that broker-dealers would pass on these direct compliance costs, in part or in full, to retail customers.

In addition to these costs, this alternative would likely cause some broker-dealers to change their current practices, which, in turn, may impose further costs on them or their retail

customers. As discussed above in Section III.B.2.e.ii some studies find evidence suggesting that firms have adjusted their practices, at least in the short-run, in response to the DOL fiduciary Rule. In particular, certain of these studies observe that in certain cases some broker-dealers have either eliminated or reduced access to brokerage advice services. Other studies observe that some broker-dealers migrated toward fee-based advisory services or limited brokerage services (i.e., no provision of advice) and, in the process, offered their retail customers the option to shift from commission-based brokerage accounts to fee-based accounts, automated investment accounts or self-directed accounts. Some of their customers chose to not move to a fee-based account.

Certain studies provide evidence suggesting that some broker-dealers adjusted the range of their offerings.[1366] Specifically, according to these studies, some of the respondents reduced or eliminated access to certain assets or share classes, such as certain mutual funds or mutual fund share classes, and or annuity securities offered.

Finally, there is some anecdotal evidence that suggests that certain firms changed the compensation structure for their associated persons.[1367] Specifically, some firms equalize commissions and deferred sales charges across similar securities, while other firms banned sales quotas, contests, and certain bonuses.

1366 *See supra* Section III.B.2.e.ii.

1367 *See id.*

To the extent that the fiduciary standard in this alternative would result in similar responses by broker-dealers, the alternative would impose cost on retail customers relative to the baseline. For example, switching a retail customer from a commission-based brokerage account to a different type of account, such as fee-based advisory account, may leave a customer worse off in certain circumstances. For instance, a retail customer who is a buy-and-hold investor may overpay for the advice typically associated with this type of investment strategy if the retail customer were to shift from a brokerage account to a fee-based account.[1368] As another example, a retail customer would lose access to occasional personalized advice if he or she were to shift from his or her brokerage account to a self-directed account.

The cost to retail customers from switching to a suboptimal account is particularly important in the context of IRA brokerage accounts, because of the larger size of these accounts and the importance of these accounts for retail investors to meet their retirement needs. These costs may also be higher for IRA brokerage accounts than for other account types to the extent that these accounts include long-term, buy-and-hold investments. As discussed in Section III.B.2.e.ii, one study provided an estimate for this potential cost.[1369] However, as discussed above, the estimates provided by various studies, including this one, or by commenters are

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[1368] *See supra* footnote 1354.

[1369] *See* SIFMA Study.

generally subject to assumptions or methodological limitations which may affect the inferences based on such estimates.

In addition to the evidence discussed above, there are other potential economic implications of this alternative. For instance, this alternative may exclude from the market for investment advice those retail customers that have account balances that are below the account minimum for typical advisory accounts. The investment advisory industry might adjust to a lack of supply by accommodating lower account balances. However, because investment advisers have a fiduciary duty to all their clients, and because they have limited time and resources, there is likely a limit to how much an investment adviser can lower his or her account minimum to accommodate more advisory clients. Similarly, the product market may adjust by innovating new products to accommodate retail customers with account balances that are below the typical advisory account minimum. For example, hybrid products that implement automated investment strategies tailored to a retail customer's goals may substitute for the services of an investment adviser for customers with lower account balances.

2. Prescribed Format for Disclosure

Although Regulation Best Interest specifies the required content of disclosure necessary to meet a broker-dealer's Disclosure Obligation, it does not prescribe a specific format for that

disclosure. As an alternative, and as suggested by commenters,[1370] we considered requiring broker-dealers to use a specific form similar to, for example, Form ADV.

Because this alternative would still impose all the obligations of Regulation Best Interest, all the benefits and the costs identified in Regulation Best Interest would carry over to this alternative as well. However, by changing the way broker-dealers would meet the Disclosure Obligation, this alternative may create additional benefits and impose additional costs.

[1370] *See, e.g.*, LPL August 2018 Letter that notes that "all investors should be provided with general disclosures somewhat akin to those contained in Form ADV Part 2A—e.g., which set forth the ranges of remuneration payable to a broker-dealer in connection with its recommendations of different products… [W]e believe that detailed product-specific disclosures should be required prior to or at the time of a recommendation only in instances where the remuneration associated with the recommendation exceeds the previously disclosed range or where the recommendation implicates a conflict of interest that has not previously been disclosed. In all other cases, a broker-dealer should be permitted to satisfy its Disclosure Obligation by directing an investor in writing to review the recommended product's offering documents and providing hyperlinks to those documents (or providing a hyperlink to a central page on the broker-dealer's website that contains hyperlinks to the product documents), either prior to the recommendation via a general Form ADV Part 2A-like disclosure document or shortly thereafter via a trade confirmation." *See also* Morningstar Letter, noting "publicly available disclosures with a standard taxonomy work best because they empower third parties such as 'fintech' and 'reg-tech' firms to analyze and contextualize critical information and amplify a call to action for ordinary investors." *See also* Letter from Peter J. Chepucavage (May 31, 2018) ("Chepucavage Letter"), noting that "[c]osts for the small bd's however can be reduced with a commission approved standard disclosure which would add certainty and ought to be considered especially for the small investor. […] A standard disclosure document would also be useful for the small bd that cannot afford the legal assistance needed to evaluate this 1,000 page proposal and draft appropriate documents. […] The Commission should therefore reconsider the impact of its proposal on small investors and small bd's with the assumption that retirement accounts are significantly more important than regular brokerage accounts especially for small and elderly investors. A standard disclosure for small firms would reduce costs for the firms and their customers."

The requirement to use a form similar to Form ADV to meet the Disclosure Obligation would put more structure on the disclosure of material facts relating to the scope and terms of the relationship with the retail customer and material facts relating to conflicts of interest that are associated with a recommendation. This added structure would facilitate retail customers' comparison of multiple broker-dealers, which would benefit retail customers. For example, the evidence provided by the investor testing surveys suggests that retail customers form preference over various variables that are being disclosed.[1371] On the backdrop of this evidence, the structured disclosure provided by a specific form may enhance a retail customer's ability to select a broker-dealer in a manner consistent with his or her preferences. In addition, the structured disclosure provided by a form may allow a third party to collect the information disclosed by firms, process it, and present it to retail customers in a way that would make it easier for the retail customer to select a broker-dealer. To the extent the format of disclosure under this alternative would result in this potential outcome, the alternative would further benefit retail customers.

However, the requirement to use a form similar to Form ADV to meet the Disclosure Obligation may also impose costs on broker-dealers, at least in the short run, to the extent that this form of disclosure is different from the form of disclosure that firms employ currently to satisfy their disclosure obligations and liabilities under the baseline. In general it may be difficult

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[1371] *See* Relationship Summary Adopting Release for a discussion of the evidence provided by the investor testing surveys.

to design a form that, while comprehensive in terms of capturing the diversity of business practices that broker-dealers employ, remains easy to understand for retail customers. In general, given that there is a wide variety of business models and practices, there is value in providing broker-dealers with flexibility to enable them to better tailor disclosure and information that their retail customers can understand and may be more likely to read at relevant points in time, rather than, for example, mandating a standardized all-inclusive (and likely lengthy) disclosure. Depending on the specific form that is eventually mandated, some firms may incur more costs than others. To the extent firms pass on those costs to retail customers, the alternative would impose a cost on retail customers.

3. Disclosure-Only

Another potential alternative to addressing the agency costs of obtaining advice from broker-dealers is a disclosure-only alternative, which would require that broker-dealers satisfy only the Disclosure Obligation of Regulation Best Interest. In other words, broker-dealers would be required to provide the retail customer, in writing, full and fair disclosure of all material facts relating to the scope of the relationship with the retail customer and all material facts relating to the conflicts of interest associated with the recommendations to the retail customer, prior to or at the time of the recommendation. However, this alternative would not impose either the Care Obligation or the Conflict of Interest Obligation.

As discussed in Sections III.C.2 and III.C.4, there may be substantial overlap between the disclosure requirements of Regulation Best Interest and the disclosure requirements under the regulatory baseline. From this perspective, relative to the regulatory baseline, the cost of this alternative to the broker-dealers may be small, at least for some broker-dealers. However, as pointed out above, a disclosure-only alternative is not likely to address the agency costs

associated with obtaining advice from broker-dealers. As a result, the Commission believes both specific disclosure and mitigation requirements are needed to address those conflicts. Also, we noted above that sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities within a limited period of time create high-pressure situations for associated persons to increase the sales of specific securities by compromising the best interest of their customers; the Commission does not believe such conflicts of interest can be reasonably mitigated, let alone disclosed, in a manner that adequately prevents harm to retail customers and, accordingly, believes that these conflicts must be eliminated in their entirety.

Finally, as we discussed earlier, commenters noted that there are limits to the effectiveness of disclosure and cited a number of studies suggesting that disclosure alone is unlikely to solve the issues surrounding, for example, the conflicts of interest between a broker-dealer (or their associated persons) and a retail customer.[1372]

IV. PAPERWORK REDUCTION ACT

Certain provisions of Regulation Best Interest and the rule amendments that we are adopting today contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[1373] The Commission submitted Regulation Best Interest and the rule amendments to the Office of Management and Budget ("OMB") for review

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[1372] *See supra* footnote 1208 and accompanying text. *See also supra* Section III.B.4.c for a discussion of the literature on the effectiveness of disclosure.

[1373] 44 U.S.C. 3501 *et seq.*

and approval in accordance with the PRA.[1374] The Commission's earlier PRA assessments have been revised to reflect the modifications to the rule and amendments from the Proposing Release, as well as additional information and data provided to the Commission by commenters. 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. The titles and OMB control numbers for the collections of information are:

Rule	Rule Title	OMB Control Number
Rule 15*l*-1	Regulation Best Interest	
Rule 17a-3	Records to be made by certain exchange members, brokers and dealers[1375]	3235-0033
Rule 17a-4	Records to be preserved by certain exchange members, brokers and dealers[1376]	3235-0279

Regulation Best Interest enhances the broker-dealer standard of conduct beyond existing suitability obligations, and aligns the standard of conduct with retail customers' reasonable expectations by requiring broker-dealers, among other things, to: (1) comply with specific obligations to make recommendations that are in the best interest of the retail customer, and that

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1374 *See* 44 U.S.C. 3507(d); 5 CFR 1320.11.

1375 *See* 17 CFR § 240.17a-3. The addition of paragraph (a)(35) to Rule 17a-3 would amend the existing PRA for Rule 17a-3.

1376 *See* 17 CFR § 240.17a-4. The amendment to Rule 17a-4(e)(5) would amend the existing PRA for Rule 17a-4.

do not place the broker-dealer's interests ahead of the interests of the retail customer; and (2) address conflicts of interest by fully and fairly disclosing material facts about conflicts of interest, and in instances where we believe disclosure is insufficient to reasonably address the conflict, establish, maintain and enforce policies and procedures reasonably designed to mitigate or, in certain instances, eliminate the conflict. Generally, in crafting 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 amendments under Rule 17a-3(a)(35) and Rule 17a-4(e)(5).

In the Proposing Release, we requested comment on the matters discussed in the PRA, including our estimates for the new and recurring burdens and associated costs described in connection with Regulation Best Interest and the amendments under Rule 17a-3(a)(35) and Rule 17a-4(e)(5).[1377] In particular, we sought comment on estimates as to: (1) the 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

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[1377] The Proposing Release proposed to add new paragraph (a)(25) of Rule 17a-3. As noted above, we are adopting the provision substantially as proposed but redesignating it as new paragraph (a)(35) of Rule 17a-3. *See supra* footnote 820 and accompanying text.

or burdens[1378] associated with proposed Regulation Best Interest that had not been identified in the Proposing Release.

As discussed in Sections I, II, and III, we received comments that addressed whether we could minimize the burden of the proposed collections of information. We received several comments suggesting that our estimated burdens and costs for the rule as a whole were too low.[1379] In addition, the Commission received some comments specifically addressing the costs to smaller broker-dealers.[1380] Also, as discussed in the Economic Analysis section above, we received comments regarding the potential costs and burdens of proposed Regulation Best

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[1378] Throughout the PRA analysis in the Proposing Release, the burdens on in-house personnel were measured in terms of burden hours, and external costs were expressed in dollar terms.

[1379] *See, e.g.,* NSCP Letter; *see also* CCMC Letters (costs to implement the proposal were underestimated and greater than 40% of firms surveyed anticipate having to spend a moderate or substantial amount to implement Regulation Best Interest and Form CRS); Raymond James Letter (noting the significant implementation costs of Regulation Best Interest and Form CRS for the industry); SIFMA August 2018 Letter (stating that implementation costs of Regulation Best Interest and Form CRS would be significant).

[1380] *See, e.g.*, Chepucavage Letter (finding that the estimates in the proposal are severely understated unless they are excluding time needed for review of the proposal and final rule and suggesting the Commission reconsider the impact on small investors and small broker-dealers); NSCP Letter (requesting the Commission to consider the financial and operational impacts of the proposed rule, particularly on small firms, and to minimize those impacts, given that small firms do not have compliance departments adequate to deal with increasing regulatory demands). *See also, e.g.,* Iowa Insurance Commissioner Letter; Letter from David S. Addington, National Federation of Independent Business (May 30, 2018) ("NFIB Letter").

Interest on broker-dealers.[1381] In response, we have modified several substantive requirements to the rule by, among other things, providing more specificity in the rule text in the Disclosure and Conflict of Interest Obligations, which we believe will mitigate some of these burdens and costs relative to the Proposing Release.[1382] At the same time, certain modifications, such as maintaining a written record of oral disclosure, resulted in new burdens and costs, relative to those addressed in the Proposing Release, which are reflected below.

A. Respondents Subject to Regulation Best Interest and Amendments to Rule 17a-3(a)(35) and Rule 17a-4(e)(5)

1. Broker-Dealers

Regulation Best Interest imposes 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 Advisers Act, would be subject to new, distinct burdens under Regulation Best Interest.

As of December 31, 2018, 3,764 broker-dealers were registered with the Commission, either as standalone broker-dealers or as dually registered entities.[1383] Based on data obtained

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1381 *See supra* Section III.

1382 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.

1383 The Commission estimated the number of respondents in the Proposing Release as of December 31, 2017. The Commission is updating its estimated number of broker-dealers

from Form BR, the Commission believes that approximately 73.5% of this population, or 2,766 broker-dealers, have retail customers and therefore would be subject to Regulation Best Interest and the amendments under Rules 17a-3(a)(35) and 17a-4(e)(5).[1384] Further, based on FOCUS Report data,[1385] the Commission estimates that as of December 31, 2018, approximately 985 broker-dealers may be deemed small entities under the Regulatory Flexibility Act.[1386] Of these,

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to reflect the number of broker-dealers registered with the Commission as of December 31, 2018.

1384 As of December 31, 2018, 3,764 broker-dealers filed Form BD. Retail sales by broker-dealers were obtained from Form BR. As discussed above in Section III.B.1.a, the number of broker-dealers that serve retail customers (*i.e.*, 2,766) likely overstates the number of broker-dealers that will be subject to Regulation Best Interest, because not all broker-dealers that serve retail investors provide recommendations to retail investors. We do not have reliable data to determine the precise number of broker-dealers that provide recommendations, and as a result, we have assumed, for purposes of this analysis that 2,766 broker-dealers will be subject to Regulation Best Interest.

1385 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.

1386 *See infra* Section V for an explanation of which brokers-dealers, subject to Regulation Best Interest, are "small entities," for purposes of the Regulatory Flexibility Act analysis.

The Commission's estimate is obtained from Form BD filings. Although Form BD filings are updated on a more frequent basis than annually, FOCUS data, which also informs this baseline with respect to broker-dealers, is only sparsely updated throughout the year. Moreover, instead, broker-dealers tend to make their most complete updates in the fourth calendar quarter of each year. Therefore, in order to minimize discrepancies in the broker-dealer data between Form BD and FOCUS data, we have normalized all of the data to the most recently complete FOCUS data, which is for December 2018.

approximately 756 have retail business.[1387] Therefore, we estimate that 2,010 broker-dealers would qualify as large broker-dealers with retail customers for purposes of this analysis.[1388]

2. Natural Persons Who Are Associated Persons of Broker-Dealers

As with broker-dealers, Regulation Best Interest imposes 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 believes that approximately 428,404 natural persons would qualify as retail-facing, registered representatives at standalone broker-dealers or dually registered firms,[1389] and would therefore be subject to Regulation Best Interest.[1390]

1387 *Id.*

1388 This calculation was made as follows: (2,766 total retail broker-dealers) – (756 total small retail broker-dealers) = 2,010 large retail broker-dealers.

1389 *See supra* Section III.B.1 at Table 5. This estimate is based on the following calculation: (504,005 total licensed representatives (including representatives of investment advisers)) x (15% (the percentage of total licensed representatives who are standalone investment adviser representatives)) = approximately 75,601 representatives at standalone investment advisers. To isolate the number of representatives at standalone broker-dealers and dually registered firms, we have subtracted 75,601 from 504,005, for a total of 428,404 retail-facing, licensed representatives at standalone broker-dealers or dually registered firms.

1390 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.

B. Summary of Collections of Information

Regulation Best Interest requires broker-dealers and their associated persons[1391] 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 ahead of the interest of the retail customer. As discussed above, Regulation Best Interest specifically provides that this best interest obligation shall be satisfied if the broker-dealer complies with the specific Disclosure, Care, Conflict of Interest, and Compliance Obligations.

Rule 17a-3 requires a broker-dealer to make and keep current certain records. The Commission is amending this rule by adding new paragraph (a)(35) to impose new record-making obligations on broker-dealers subject to Regulation Best Interest. Rule 17a-4 requires a broker-dealer to preserve certain records if it makes or receives them. The Commission is amending Rule 17a-4(e)(5) to impose new record retention obligations on broker-dealers subject to Regulation Best Interest.

The obligations arising under Regulation Best Interest and the amendments under Rule 17a-3(a)(35) and Rule 17a-4(e)(5) would give rise to distinct collections of information and

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[1391] However, in certain instances, as described more fully below, the Commission assumes that broker-dealers will undertake certain Disclosure Obligations on behalf of their registered representatives. *See, e.g., infra* footnote 1397.

associated costs and burdens for broker-dealers subject to the rules. The collections of information associated with Regulation Best Interest and rule amendments are described below.

1. Disclosure Obligation

The Disclosure Obligation under Regulation Best Interest requires a broker, dealer, or natural person who is an associated person of a broker or dealer, prior to or at the time of recommending a securities transaction or strategy involving securities to a retail customer, to provide the retail customer, in writing, full and fair disclosure of: (1) all material facts relating to the scope and terms of the relationship with the retail customer, including (a) 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, (b) the fees and costs that apply to the retail customer's transactions, holdings, and accounts, and (c) 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 (2) all material facts relating to conflicts of interest that are associated with the recommendation. The Commission believes that requiring broker-dealers to disclose to a retail customer, in writing, all material facts relating to the scope and terms of the relationship with the retail customer would facilitate the retail customer's understanding of the nature of his or her account, the broker-dealer's fees and costs, as well as the nature of services that the broker-dealer provides, as well as any limitations to those services. It would also provide retail customers with information to better understand the differences among certain financial service providers, such as broker-dealers, investment advisers, and dually registered firms and dually registered financial professionals. In addition, the obligation to disclose all material facts relating to conflicts of interest that are 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.

We are explicitly requiring in the rule text of Regulation Best Interest, items that the Proposing Release had only provided as examples of "material facts relating to the scope and terms of the relationship with the retail customer" that must be disclosed, namely: (1) that the broker, dealer or such natural person is acting as a broker, dealer or an associated person of a broker-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. We generally believe the proposed burdens and costs identified in the Proposing Release were accurate but have updated estimates to reflect changes in the number of broker-dealers and costs of certain services since the last estimate. The collections of information associated with the Disclosure Obligation, as well as the associated record-making and recordkeeping obligations are addressed below.

a. Obligation to Provide to the Retail Customer Full and Fair Disclosure, in Writing, of all 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 the obligation to disclose to the retail customer, in writing, the material facts related 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 type and scope of services, and the development of fee schedules.

(1) Disclosure of Capacity

As discussed above, the Commission 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 Adopting Release.[1392]

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 the method the broker-dealer planned to use to clarify its capacity at the time of the recommendation. We understand that many broker-dealers already include such information in account disclosures.

(2) Disclosure of Fees and Costs and Type and Scope of Services, Including Any Material Limitations on the Securities or Investment Strategies that may be Recommended

While many broker-dealers provide fee information to retail customers in a fee schedule, the Commission believes that to comply with the Disclosure Obligation broker-dealers will either amend their existing schedules or develop a new standardized fee schedule to disclose the fees and costs applicable to retail customers' transactions, holdings, and accounts. This fee schedule

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1392 *See* Relationship Summary Adopting Release.

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 and costs of the particular recommendation, the broker-dealer would need to deliver an amended fee schedule or provide an oral update, under the circumstances outlined in Section II.C.1.

With respect to disclosure of the type and scope of services provided by the broker-dealer, including any material limitations on the securities or investment strategies that may be recommended to the retail customer, we assume for purposes of this PRA analysis that a broker-dealer 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 or provide an oral update, under the circumstances outlined in Section II.C.1.

b. Obligation to Provide to the Retail Customer Full and Fair Disclosure, in Writing, of All Material Facts Relating to Conflicts of Interest that are Associated with the Recommendation

Regulation Best Interest requires a broker-dealer to provide the retail customer, in writing, full and fair disclosure of all material facts relating to conflicts of interest that are associated with a recommendation.

As discussed above, we assume that broker-dealers will satisfy the obligation to disclose all material facts relating to conflicts of interest through the use of: (1) a standardized, written disclosure document provided to all retail customers and (2) supplemental disclosure provided to certain retail customers for recommendations of specific products.

We assume for purposes of this analysis that delivery of written disclosure will occur at the beginning of a relationship, such as together with the account opening agreement. For existing retail customers, the disclosure will need to occur "prior to or at the time" of a recommendation. Subsequent disclosures may be delivered or the broker-dealer may provide an oral update, under the circumstances outlined in Section II.C.1, 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.[1393]

c. Estimated Costs and Burdens

(1) Disclosure of Capacity, Type and Scope of Services

Standalone broker-dealers will satisfy the obligation to disclose the capacity in which they are acting through the delivery to retail customers of the Relationship Summary, in accordance with the rules and guidance set forth in the Relationship Summary Adopting Release. Additionally, although we understand that many dual-registrants and standalone broker-dealers, as a matter of best practice, already disclose the capacity in which they are acting as well as the and type and scope of services they offer to retail customers, for purposes of this analysis, we assume that dual-registrants would create new account disclosure related to capacity and all

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[1393] The costs and burdens arising from the obligation to identify all material conflicts of interest that are associated with the recommendation are addressed below, in the context of the Conflict of Interest Obligation, in Section V.B.1.

broker-dealers would create or update account disclosure related to type 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 associated persons, we do not expect associated persons to incur any initial or ongoing burdens with respect to the 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.[1394] With regard to disclosure of the capacity in which the associated person is acting, the Commission believes that dually registered representatives of broker-dealers will incur initial and ongoing burdens.[1395]

Following is a discussion of the estimated initial and ongoing burdens and costs.

i. Initial Costs and Burdens

[1394] A broker-dealer or an associated person may satisfy the Disclosure Obligation by using oral disclosure if it has previously provided written disclosure to the retail customer beforehand as well as the method it planned to use to clarify the disclosure at the time of the recommendation. In addition, a record of the fact of such oral disclosure having been made must be created and retained. We assume that any disclosure required of a registered representative will be made orally, and that any ongoing costs and burdens will be associated with the record-making memorializing the fact of the oral disclosure. *See* Section IV.B.5 (discussing the costs and burdens associated with record-making).

[1395] *See supra* Section IV.B.5 (discussing the costs and burdens associated with record-making).

Because, as noted above, standalone broker-dealers will satisfy the obligation to disclose the capacity in which they are acting through the delivery to retail customers of the Relationship Summary, we estimate zero burden hours for standalone broker-dealers to disclose the capacity in which they are acting. We estimate that a dually registered firm will incur an initial internal burden of 10 hours for in-house counsel and in-house compliance[1396] to draft language regarding the capacity in which they are acting for inclusion in the standardized account disclosure that is delivered to the retail customer.[1397]

In addition, we estimate that dual-registrants will incur an estimated external cost of $4,970 for the assistance of outside counsel in the preparation and review of standardized language regarding capacity.[1398] For the estimated 563 dually registered firms with retail

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1396 The ten hour estimate includes five hours for in-house counsel to draft and review the standardized language, and five hours for consultation and review of compliance personnel.

1397 As discussed above, the following estimates include the costs and burdens that broker-dealers would incur in drafting standardized account disclosure language related to the scope and terms of the relationship on behalf of their dually registered representatives. For purposes of this analysis, the Commission assumes that broker-dealers will undertake these tasks on behalf of their registered representatives. *See* Section IV.B.5 (discussing the costs and burdens associated with record-making).

1398 Data from the Securities Industry Financial Markets Association's Management & Professional Earnings in the Securities Industry 2013 ("SIFMA Management and Professional Earnings Report"), modified by Commission staff to account for an 1,800-hour work-year and inflation, and multiplied by 5.35 (professionals) or 2.93 (office) to account for bonuses, firm size, employee benefits, and overhead, suggests that costs for this position is $497 per hour. The SIFMA Management and Professional Earnings Report was updated in 2019 to reflect inflation. The numbers in the report are higher

business,[1399] we project an aggregate initial burden of 5,630 hours,[1400] and $2.8 million in aggregate initial costs relating to disclosure of the capacity in which they are acting.[1401]

Similarly, to comply with Regulation Best Interest, we believe that broker-dealers[1402] will draft standardized language for inclusion in the account disclosure to provide the retail customer with more specific information regarding the type and scope of services that they provide. We expect that the associated costs and burdens will differ between small and large broker-dealers, as large broker-dealers generally offer more products and services and therefore will need to evaluate a larger number of products and services.

Given these assumptions, we estimate that a small broker-dealer will incur an internal initial burden of 10 hours for in-house counsel and in-house compliance to draft this standardized

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than the numbers we used in the Proposing Release. This estimate is based on the following calculation: (10 hours for outside counsel review/drafting) x ($497/hour for outside counsel services) = $4,970 in initial outside counsel costs.

1399 *See supra* Section III.B.1.a, at Table 1, Panel B. The number of dually registered broker-dealers includes broker-dealers that are also Commission- and state-licensed investment advisers.

1400 This estimate is based on the following calculation: (563 dually registered retail firms) x (10 hours) = 5,630 initial aggregate burden hours.

1401 This estimate is based on the following calculation: (563 dually registered retail firms) x ($4,970 in external cost per firm) = $2.8 million in aggregate initial costs.

1402 In the Proposing Release, we inadvertently referred to "standalone broker-dealers" in this discussion, but our subsequent references and estimates reflected our intent to capture initial costs and burdens relating to disclosure of type and scope of services on all broker-dealers (distinguishing between small and large).

language.[1403] In addition, a small broker-dealer will incur an estimated external cost of $4,970 for the assistance of outside counsel in the preparation and review of this standardized language.[1404] For the estimated 756 small broker-dealers,[1405] we project an aggregate initial burden of 7,560 hours,[1406] and aggregate initial costs of $3.8 million.[1407]

Given the broader array of products and services offered, we estimate that a large broker-dealer will incur an internal burden of twenty hours to draft this standardized language.[1408] A large broker-dealer will also incur an estimated cost of $7,470 for the assistance of outside counsel in the preparation and review of this standardized language.[1409] For the estimated 2,010

1403 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 by in-house compliance.

1404 This estimate is based on the following calculation: (10 hours for outside counsel review/drafting) x ($497/hour for outside counsel services) = $4,970 in initial outside counsel costs.

1405 *See supra* footnote 1385 and accompanying text.

1406 This estimate is based on the following calculation: (756 small broker-dealers) x (10 hours per small broker-dealer) = 7,560 initial aggregate burden hours.

1407 This estimate is based on the following calculation: (756 small broker-dealers) x ($4,970 in external cost per small broker-dealer) = $3.8 million in aggregate initial outside counsel costs.

1408 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 by in-house compliance.

1409 This estimate is based on the following calculation: (15 hours for outside counsel review/drafting) x ($497/hour for outside counsel services) = $7,455 in initial outside counsel costs.

large retail broker-dealers, we estimate an aggregate initial burden of 40,200 hours[1410] and $15 million in aggregate initial costs.[1411]

We estimate that all broker-dealers will each incur approximately 0.02 burden hours[1412] for delivery of the account disclosure document.[1413] Based on FOCUS data, we estimate that the 2,766 broker-dealers that report retail activity have approximately 139 million customer accounts, and that approximately 73.5%, or 102 million, of those accounts belong to retail customers.[1414] We therefore estimate that broker-dealers will have an aggregate initial burden of 2,040,000

[1410] This estimate is based on the following calculation: (2,010 large broker-dealers) x (20 burden hours) = 40,200 aggregate initial burden hours.

[1411] This estimate is based on the following calculation: (2,010 large broker-dealers) x ($7,455 initial outside counsel costs) = $15 million in aggregate initial costs.

[1412] This is the same estimate the Commission makes in the Relationship Summary Adopting 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 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.

[1413] As noted above, for new retail customers, we expect delivery to occur at the beginning of the relationship; for existing customers, we expect delivery to occur prior to or at the time of a recommendation.

[1414] We have revised our estimates from the Proposing Release to reflect the updated FOCUS Report data. Therefore, the 2,766 broker-dealers (including dual-registrants) with retail customers report 139 million customer accounts. *See* Section III.B.1.a, at Table 1, Panel B. Assuming the amount of retail customer accounts is proportionate to the percentage of broker-dealers that have retail customers, or 73.5% of broker-dealers, then the number of retail customer accounts would be 73.5% of 139 million accounts = 102 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.

hours, or approximately 738 hours[1415] per broker-dealer for the first year after Regulation Best Interest is in effect.[1416]

We estimate a total initial aggregate burden for all broker-dealers to develop and deliver to retail customers account disclosures relating to capacity and type and scope of services of 2,093,390 burden hours.[1417] We estimate a total initial aggregate cost of $21.6 million.[1418]

ii. Ongoing Costs and Burdens

For purposes of this analysis, we assume that broker-dealers will review and amend the standardized language in the account disclosure, on average, once a year.[1419] Further, we assume

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1415 These estimates are based on the following calculations: (0.02 hours per customer account x (102 million retail customer accounts) = 2,040,000 aggregate burden hours. Conversely, (2,040,000 hours) / (2,766 broker-dealers) = approximately 738 burden hours per broker-dealer for the first year after Regulation Best Interest is in effect.

1416 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.

1417 This estimate is based on the following calculation: (5,630 aggregate initial burden hours for dual-registrants) + (7,560 aggregate initial burden hours for small broker-dealers) + (40,200 burden hours for large broker-dealers) + (2,040,000 aggregate initial burden hours for all broker-dealers to deliver the account disclosures) = 2,093,390 total aggregate initial burden hours.

1418 This estimate is based on the following calculation: ($2.8 million in initial aggregate costs for dual-registrants) + ($3.8 million in initial aggregate costs for small broker-dealers) + ($15 million in initial aggregate costs for large broker-dealers) = $21.6 million in total initial aggregate costs.

1419 We believe this annual timeframe is consistent with other obligations imposed on broker-dealers. For example, FINRA rules set an annual supervisory review as a minimum threshold for broker-dealers, for example, in FINRA Rules 3110 (requiring an annual

that broker-dealers will not incur outside costs in connection with updating account disclosures, as in-house personnel will be more knowledgeable about changes in capacity, and the type and scope of services offered by the broker-dealer. Additionally, with respect to standalone broker-dealers, because they will meet their obligation to disclose capacity by delivering the Relationship Summary, and will be subject to requirements to amend the Relationship Summary consistent with Form CRS, we estimate zero burden hours annually for ongoing costs relating to disclosure of capacity under the Disclosure Obligation.

We estimate that each dually registered broker-dealer will incur approximately five burden hours annually for in-house compliance and business-line personnel to review changes in the dual-registrant's capacity,[1420] 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, for a

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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).

1420 In the Proposing Release, we referred to capacity *and* type and scope of services, however, we captured the ongoing costs and burdens relating to disclosure of type and scope of services in the paragraphs that followed, where we inadvertently referred to "small standalone broker-dealers" and "large standalone broker-dealers," but where our calculations reflected the burdens on all "small broker-dealers" and all "large broker-dealers." *See* Proposing Release, footnotes 600-601. We believe it is appropriate to distinguish between standalone and dually registered broker-dealers in assessing the costs and burdens relating to disclosure of capacity, and to distinguish between small and large firms in assessing the costs and burdens relating to disclosure of type and scope of services, as reflected in this section.

total of seven burden hours. The estimated ongoing aggregate burden to amend dual-registrants' account disclosures to reflect changes in capacity is therefore 3,941 hours per year.[1421]

With respect to small broker-dealers, we estimate an internal burden of two hours for in-house compliance and business-line personnel to review and update changes in types or scope of services, and another two burden hours annually for in-house counsel to amend the account disclosure to disclose material changes to type and 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 type and scope of services is therefore 3,024 hours per year.[1422]

We estimate that large broker-dealers would incur ten burden hours annually for in-house compliance and business-line personnel to review and update changes the type and scope of services, and another ten burden hours annually for in-house counsel to amend the account disclosure to disclose material changes to the type and scope of services, for a total of twenty burden hours. We therefore believe the ongoing, aggregate burden is 40,200 hours per year for large broker-dealers.[1423]

[1421] This estimate is based on the following calculation: (7 burden hours per dually registered firm per year) x (563 dually registered broker-dealers) = 3,941 ongoing aggregate burden hours per year.

[1422] This estimate is based on the following calculation: (4 burden hours per broker-dealer per year) x (756 small broker-dealers) = 3,024 ongoing aggregate burden hours per year.

[1423] This estimate is based on the following calculation: (20 burden hours per broker-dealer per year) x (2,010 large broker-dealers) = 40,200 ongoing aggregate burden hours per year.

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 broker-dealer's retail customer accounts annually. We therefore estimate broker-dealers to incur a total annual aggregate burden of 408,000 hours, or 148 hours per year per broker-dealer.[1424]

The total ongoing aggregate burden for all broker-dealers to review, amend, and deliver updated account disclosures to reflect changes in capacity, type and scope of services would be 455,165 burden hours per year.[1425]

The Commission acknowledges that the types of services and product offerings vary greatly by broker-dealer, and therefore the costs and burdens associated with updating the account disclosure might also vary.

(2) Disclosure of Fees and Costs

The Commission assumes for purposes of this analysis that a broker-dealer will disclose its fees and costs through a standardized fee schedule, delivered to the retail customer at the

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1424 (20%) x (102 million retail customer accounts) x (.02 hours for delivery to each customer account) = 408,000 aggregate burden hours. Conversely, 408,000 aggregate burden hours / 2,766 broker-dealers = 148 burden hours per year per broker-dealer.

1425 This estimate is based on the following calculation: (3,941 ongoing aggregate burden hours for dually registered broker-dealers) + (3,024 ongoing aggregate burden hours for small broker-dealers) + (40,200 ongoing aggregate burden hours for large broker-dealers) + (408,000 ongoing aggregate burden hours for delivery of amended account disclosures) = 455,165 total ongoing aggregate burden hours per year.

beginning of the relationship, or, for existing retail customers, prior to or at the time of a recommendation and, as discussed below, will 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.[1426] While the Commission recognizes that the fee disclosure included in Disclosure Obligation applies to the broker-dealer entity and its associated persons, we do not expect any burdens or costs on associated persons related to the fees and costs as this information would be addressed in the broker-dealer entity's fee schedule.

i. Initial Costs and Burdens

We assume that, for purposes of this analysis, the associated costs and burdens will differ between small and large broker-dealers, as large broker-dealers generally offer more products and services and therefore will need to 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 will initially spend five hours for in-house compliance and large broker-dealers will spend ten hours for in-house compliance to internally create a new fee schedule in consideration of the requirements of Regulation Best Interest. We additionally

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[1426] Our estimates may be higher than actual, since firms may be able to use or simply update existing disclosures depending on the facts and circumstances.

estimate a one-time external cost of $2,485 for small broker-dealers[1427] and $4,970 for larger broker-dealers for outside counsel to review the fee schedule.[1428] We therefore estimate the initial aggregate burden for small broker-dealers to be 3,780 burden hours,[1429] and the initial aggregate cost to be $1.88 million.[1430] We estimate the aggregate burden for large broker-dealers to be 20,100 burden hours,[1431] and the aggregate cost to be $9.99 million.[1432]

Similar to delivery of the account disclosure regarding capacity and type 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 beginning of the relationship, and existing retail customers, prior to or at the time of a recommendation, will require approximately 0.02 hours to

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1427 This cost estimate is based on the following calculation: (5 hours of review) x ($497/hour for outside counsel services) = $2,485 outside counsel costs.

1428 This cost estimate is based on the following calculation: (10 hours of review) x ($497/hour for outside counsel services) = $4,970 outside counsel costs.

1429 This estimate is based on the following calculation: (5 burden hours of review per small broker-dealer) x (756 small broker-dealers) = 3,780 aggregate initial burden hours.

1430 This estimate is based on the following calculation: ($2,485 for outside counsel costs per small broker-dealer) x (756 small broker-dealers) = $1.88 million in aggregate initial outside costs.

1431 This estimate is based on the following calculation: (10 burden hours of review per large broker-dealer) x (2,010 large broker-dealers) = 20,100 aggregate initial burden hours.

1432 This estimate is based on the following calculation: ($4,970 for outside counsel costs per large broker-dealer) x (2,010 large broker-dealers) = $9.99 million in aggregate initial costs.

deliver to each retail customer.[1433] As stated above, we estimate that the 2,766 broker-dealers that report retail activity have approximately 139 million customer accounts, and that approximately 73.5%, or 102 million, of those accounts belong to retail customers.[1434] We therefore estimate that broker-dealers will have an aggregate initial burden of 2,040,000 hours, or approximately 738 hours per broker-dealer for the first year after Regulation Best Interest is in effect.[1435]

The total aggregate initial burden for broker-dealers is therefore estimated at 2,063,880[1436] hours, and the total aggregate initial cost is estimated at $11.87 million.[1437]

ii. Ongoing Costs and Burdens

For purposes of this PRA analysis, we assume that broker-dealers will review and amend the fee schedule on average, once a year. With respect to small broker-dealers, we estimate that

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1433 *See supra* footnote 1412.

1434 *See supra* footnote 1413.

1435 This estimate is based on the following calculation: (102 million retail customer accounts) x (.02 hours for delivery to each customer account) = 2,040,000 aggregate burden hours. Conversely, (2,040,000 aggregate burden hours) / (2,766 broker-dealers) = 738 burden hours per broker-dealer for the first year after Regulation Best Interest is in effect.

1436 This estimate is based on the following calculations: (3,780 aggregate burden hours for small broker-dealers) + (20,100 burden hours for large broker-dealers) + (2,040,000 burden hours for delivery) = 2,063,880 total aggregate initial burden hours.

1437 This estimate is based on the following calculation: ($1.88 million for small broker-dealer costs) + ($9.99 million large broker-dealer costs) = $11.87 million in total initial aggregate costs.

reviewing and updating the fee schedule will require approximately two hours for in-house compliance per year, and for large broker-dealers, we estimate that the recurring, annual burden to review and update the fee schedule will be four hours for in-house compliance for each large broker-dealer. Based on these estimates, we estimate the recurring, aggregate, annualized burden will be 1,512 hours for small broker-dealers[1438] and 8,040 hours for large broker-dealers.[1439] We do not anticipate that small or large broker-dealers will 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, and that broker-dealers will require approximately 0.02 hours to deliver the amended fee schedule to each retail customer.[1440] We therefore estimate broker-dealers would incur a total annual aggregate burden of 816,000 hours, or 295 hours per broker-dealer.[1441]

1438 This estimate is based on the following calculation: (2 burden hours per broker-dealer) x (756 small broker-dealers) = 1,512 aggregate burden hours per broker-dealer per year.

1439 This estimate is based on the following calculation: (4 burden hours per broker-dealer) x (2,010 large broker-dealers) = 8,040 aggregate burden hours per broker-dealer per year.

1440 *See supra* footnote 1412.

1441 This estimate is based on the following calculation: (40% of 102 million retail customer accounts) x (.02 hours) = 816,000 aggregate burden hours. Conversely, (816,000

The total ongoing aggregate burden for all broker-dealers to review, amend, and deliver updated account disclosures to reflect changes in fees and costs would be 825,552 burden hours per year.[1442]

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 All Material Facts Relating to Conflicts of Interest Associated with the Recommendation

Regulation Best Interest requires broker-dealers to provide a retail customer, in writing, full and fair disclosure of all material facts relating to conflicts of interest that are associated with the recommendation. Because the Disclosure Obligation applies to both the broker-dealer entity and its associated persons, the Commission expects that the broker-dealer entity and its associated persons will incur initial and ongoing burdens. However, as with the disclosure of the capacity in which they are acting and type and scope of services, we assume for purposes of this

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aggregate burden hours) / (2,766 broker-dealers) = 295 burden hours per broker-dealer per year.

1442 This estimate is based on the following calculation: (1,512 ongoing aggregate burden hours for small broker-dealers) + (8,040 ongoing aggregate burden hours for large broker-dealers) + (816,000 ongoing aggregate burden hours for delivery of amended account disclosures) = 825,552 total ongoing aggregate burden hours per year.

analysis that the broker-dealer entities will incur the costs and burdens of disclosing material conflicts of interest on behalf of their associated persons.[1443]

i. Initial Costs and Burdens

The Disclosure Obligation provides broker-dealers with the flexibility to choose the form and manner of conflict disclosure. However, we believe that many or most broker-dealers will develop a standardized conflict disclosure document and deliver it to their retail customers.[1444] We also assume for purposes of this PRA analysis that broker-dealers will update and deliver the standardized conflict disclosure document yearly on an ongoing basis, following the broker-dealer's annual conflicts review process.

For purposes of this PRA analysis, we assume that a standardized conflict disclosure document will be developed by in-house counsel and reviewed by outside counsel. For small broker-dealers, we estimate it will take in-house counsel, on average, five burden hours to create the standardized conflict disclosure document and outside counsel five hours to review and revise the document. We estimate that the initial aggregate burden for the development of a standardized disclosure document, based on an estimated 756 small broker-dealers, will be 3,780

1443 *See* Section IV.B.5 (discussing the costs and burdens associated with record-making, including for associated persons of a broker-dealer).

1444 As noted above, we assume that delivery for new customers will occur at the beginning of the relationship, and that delivery for existing customers will occur prior to or at the time a recommendation is made.

burden hours.[1445] We additionally estimate an initial cost of $2,485 per small broker-dealer,[1446] and an aggregate initial cost of $1.88 million for all small broker-dealers.[1447]

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 will need to disclose a larger number of conflicts. We estimate that for large broker-dealers, it will take 7.5 burden hours for in-house counsel to create the standardized conflict disclosure document, and outside counsel will 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 2,010 large broker-dealers, to be approximately 15,075 burden hours.[1448] We additionally estimate

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1445 This estimate is based on the following calculation: (5 hours) x (756 small broker-dealers) = 3,780 aggregate initial burden hours.

1446 This estimate is based on the following calculation: ($497/hour) x (5 hours) = $2,485 in initial costs.

1447 This estimate is based on the following calculation: ($497/hour x 5 hours) x (756 small broker-dealers) = $1.88 million in aggregate initial costs.

1448 This estimate is based on the following calculation: (7.5 hours x 2,010 large broker-dealers) = 15,075 aggregate initial burden hours.

initial costs of $3,728 per broker-dealer,[1449] and an aggregate initial cost for large broker-dealers of approximately $7.49 million.[1450]

We assume that broker-dealers will 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 will require approximately 0.02 hours to deliver the standardized conflict disclosure document to each retail customer.[1451] We therefore estimate that broker-dealers will incur an aggregate initial burden of 2,040,000 hours, or approximately 738 hours per broker-dealer for delivery of the standardized conflict disclosure document the first year after Regulation Best Interest is in effect.[1452]

1449 This estimate is based on the following calculation: ($497/hour) x (7.5 hours) = $3,728 in initial costs per broker-dealer.

1450 This estimate is based on the following calculation: ($497/hour) x (7.5 hours) x 2,010 large broker-dealers) = $7.49 million in aggregate costs.

1451 *See supra* footnote 1412. For purposes of this PRA analysis, we have assumed any initial disclosures made by the broker-dealer related to material conflicts of interest will be delivered together.

1452 These estimates are based on the following calculations: (0.02 hours per customer account x 102 million retail customer accounts) = 2,040,000 aggregate initial burden hours. Conversely, (2,040,000 hours) / (2,766 broker-dealers) = 738 burden hours per broker-dealer.

The total aggregate initial burden for broker-dealers is therefore estimated at 2,058,855[1453] hours, and the total aggregate initial cost is estimated at $9.37 million.[1454]

ii. Ongoing Costs and Burdens

We believe that broker-dealers will incur ongoing annual burdens and costs to update the disclosure document to include newly identified conflicts. We assume for purposes of this analysis that broker-dealers will update their conflict disclosure document annually, after conducting an annual conflicts review. We estimate that the conflicts disclosures will be updated internally by both small and large broker-dealers.

We estimate that in-house counsel at a small broker-dealer will require approximately one hour per year to update the standardized conflict disclosure document, for an ongoing aggregate, annual burden of approximately 756 hours.[1455] For large broker-dealers, we estimate that the ongoing, aggregate annual burden would be two hours for each broker-dealer: one hour for in-house compliance and one hour for in-house counsel for legal personnel. We therefore estimate the ongoing, aggregate burden for large broker-dealers to be approximately 4,020

1453 This estimate is based on the following calculations: (3,780 aggregate burden hours for small broker-dealers) + (15,075 burden hours for large broker-dealers) + (2,040,000 burden hours for delivery) = 2,058,855 total aggregate initial burden hours.

1454 This estimate is based on the following calculation: ($1.88 million for small broker-dealer costs) + ($7.49 million large broker-dealer costs) = $9.37 million in total aggregate initial costs.

1455 This estimate is based on the following calculation: (1 hour per broker-dealer) x (756 small broker-dealers) = 756 aggregate burden hours per year.

burden hours.[1456] We do not anticipate that small or large broker-dealers will 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 will take place among 40% of a broker-dealer's retail customer accounts annually, and that broker-dealers will require approximately 0.02 hours to deliver the updated conflict disclosure document to each retail customer.[1457] We therefore estimate that broker-dealers will incur an ongoing, aggregate annual burden of 816,000 hours, or 295 burden hours per broker-dealer.[1458] The total aggregate ongoing burden for broker-dealers is therefore estimated at 820,776 hours.[1459]

1456 This estimate is based on the following calculation: (2 hours per broker-dealer) x (2,010 large broker-dealers) = 4,020 aggregate burden hours per year.

1457 *See supra* footnote 1412. The Commission estimates that broker-dealers will update their disclosures of fees and costs and material facts relating to conflicts of interest that are associated with their recommendation more frequently than disclosure related to capacity or type and scope of services.

1458 This estimate is based on the following calculation: (40% of 102 million retail customer accounts) x (.02 hours) = 816,000 aggregate burden hours per year. Conversely, (816,000 aggregate burden hours) / (2,766 broker-dealers) = 295 hours per broker-dealer per year.

1459 This estimate is based on the following calculations: (756 aggregate burden hours for small broker-dealers) + (4,020 aggregate burden hours for large broker-dealers) + (816,000 aggregate burden hours for delivery) = 820,776 total aggregate ongoing burden hours.

Based on the calculation describe above, we estimate that broker-dealers will incur an aggregate total initial burden of 6,216,125 hours[1460] and a total initial cost of $42.84 million,[1461] as well as an aggregate total ongoing annual burden of 2,101,493 hours[1462] to comply with the Disclosure Obligation.

2. Care Obligation

The Care Obligation requires a broker-dealer to have a reasonable basis to believe, based on its understanding of the potential risks, rewards, and costs of the recommended security or investment strategy involving securities, and in light of the retail customer's investment profile,

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1460 This estimate is based on the following calculation: (2,093,390 aggregate initial burden hours for initial compliance with disclosure of capacity and type and scope of services) + (2,063,880 aggregate initial burden hours for initial compliance with disclosure of fees and costs) + (2,058,855 aggregate initial burden hours for initial compliance with disclosure of all material facts regarding disclosure of conflicts of interest associated with the recommendation) = 6,216,125 total aggregate initial burden hours for compliance with the Disclosure Obligation.

1461 This estimate is based on the following calculation: ($21.6 million aggregate initial cost for compliance with disclosure of capacity and type and scope of services) + ($11.87 million aggregate initial cost for compliance with disclosure of fees and costs) + ($9.37 aggregate initial cost for compliance with disclosure of all material facts regarding disclosure of conflicts of interest associated with the recommendation) = $42.84 million total aggregate initial cost for compliance with the Disclosure Obligation.

1462 This estimate is based on the following calculation: (455,165 aggregate annual burden hours for ongoing compliance with disclosure of capacity and type and scope of services) + (825,552 aggregate annual burden hours for ongoing compliance with disclosure of fees and costs) + (820,776 aggregate annual burden hours for ongoing compliance with disclosure of all material facts regarding disclosure of conflicts of interest associated with the recommendation) = 2,101,493 total aggregate burden hours per year for ongoing compliance with the Disclosure Obligation.

that the recommendation is in the best interest of the particular retail customer and does not place the broker-dealer's interest ahead of the retail customer's interest. However, any PRA burdens or costs associated with the Care Obligation are duplicative of costs associated with other obligations in Regulation Best Interest, including the Disclosure Obligation and the Record-Making Obligation under Rule 17a-3(a)(35) and Recordkeeping Obligation under Rule 17a-4(e)(5).

3. Conflict of Interest Obligation

The Conflict of Interest Obligation creates an overarching obligation to require broker-dealers[1463] to establish written policies and procedures reasonably designed to identify and at a minimum disclose, pursuant to the Disclosure Obligation, or eliminate all conflicts of interest associated with a recommendation. More specifically, broker-dealers are specifically required to establish, maintain, and enforce written policies and procedures reasonably designed to: (i) identify and mitigate any conflicts of interest associated with 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 or dealer, or such natural person making the recommendation, ahead of the interest of the retail customer; (ii) (A) identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail

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[1463] As discussed above, the Conflict of Interest Obligation and Compliance Obligation apply solely to the broker or dealer entity, and not to the associated persons of a broker or dealer.

customer and any conflicts of interest associated with such limitations, in accordance with the Disclosure Obligation, and (B) 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 (iii) identify and eliminate sales contests, 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.[1464]

Written policies and procedures developed pursuant to the Conflict of Interest Obligation of Regulation Best Interest would help a broker-dealer to develop a process reasonably designed for its business, for identifying conflicts of interest, and then determining whether to eliminate, or disclose and/or mitigate the conflict and the appropriate means of eliminating, disclosing and/or mitigating the conflict. In addition, establishing and maintaining written policies and procedures would generally (1) assist a broker-dealer in supervising its associated persons and assessing compliance with the Conflict of Interest Obligation; and (2) assist the Commission and SRO staff in connection with examinations and investigations.[1465]

[1464] Rule 15*l*-1 under the Exchange Act.

[1465] *See* Section II.C.3.a.

Any written policies and procedures developed pursuant to 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 procedures

In light of the modifications to several substantive requirements of the rule relative to the Proposing Release, including the Conflict of Interest Obligation, as discussed in more detail above, we believe these changes will allow broker-dealers' to more easily incorporate the requirements of Regulation Best Interest into existing supervisory and compliance systems and streamline compliance with Regulation Best Interest.[1466] Therefore, we generally believe our proposed burdens and costs are accurate but have updated estimates to reflect changes in the number of broker-dealers and costs of certain services since the last estimate in the Proposing Release.

Following is a detailed discussion of the estimated costs and burdens associated with the Conflict of Interest Obligation.

a. Written Policies and Procedures

i. Initial Costs and Burdens

We believe that most broker-dealers have policies and procedures in place to address conflicts of interest, but do not necessarily have written policies and procedures regarding the identification and management of conflicts as required by Regulation Best Interest. To comply

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of the broker-dealer with respect to compliance with applicable laws and rules, and supervision of the activities of each associated, for a specified period of time. The record retention requirements of Rule 17a-4(e)(7) include any written policies and procedures that broker-dealers may produce pursuant to the Conflict of Interest Obligation of Regulation Best Interest.

1466 *See* Section II.C.3.

with the Conflict of Interest Obligation, we believe that broker-dealers would utilize a combination of in-house and outside legal and compliance counsel to update existing policies and procedures.[1467] 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 of interest. As discussed above, we estimate that 2,010 broker-dealers would qualify as large broker-dealers for purposes of this analysis and 756 would qualify as small broker-dealers that have retail business.[1468]

In the Proposing Release, we estimated that a large broker-dealer would incur a one-time internal burden of 60 hours for in-house legal and in-house compliance counsel to update existing policies and procedures to comply with Regulation Best Interest.[1469] We also estimated a cost of $4,720 for outside counsel to review updated policies and procedures on behalf of a large broker-dealer, with an aggregate initial burden of 123,300 burden hours and aggregate initial cost of $9.70 million for large broker-dealers.[1470]

In the Proposing Release, we assumed that small broker-dealers would primarily rely on outside counsel to update existing policies and procedures, as small broker-dealers generally

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1467 *See* footnote 1382 and accompanying text.

1468 *See* footnote 1388 and accompanying text.

1469 *See* Proposing Release at 21666.

1470 *Id.*

have fewer in-house legal and compliance personnel. Given that smaller broker-dealers generally have fewer conflicts of interest, we estimated that 40 hours of outside legal counsel services would be required, for a one-time cost of $18,800 per small broker-dealer, and an aggregate cost of $15.1 million for all small broker-dealers, and we also expected that 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.[1471] Therefore, we estimated the total initial aggregate burden to be 131,320 hours and the total initial aggregate cost to be $24.8 million.[1472]

We believe our estimates are generally accurate in light of the increased specificity in Regulation Best Interest as to how a broker-dealer must address specified conflicts of interest but due to changes in the number of broker-dealers and cost estimates for certain services, we are revising our burden and cost estimates.[1473]

For purposes of Regulation Best Interest as adopted, we estimate that a large broker-dealer would incur an initial burden of 50 hours for in-house counsel and in-house compliance to update existing policies and procedures to comply with Regulation Best Interest and an initial burden of 5 hours for general counsel and 5 hours for a Chief Compliance Officer to review and

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1471 *Id.*

1472 *Id.*

1473 We have revised our cost estimates to reflect the updated SIFMA Management and Professional Earnings Report which was updated in 2019 to reflect inflation. Therefore, the hourly rates used here for certain services, for example, outside legal counsel and outside compliance costs, are higher than the numbers in the Proposing Release.

approve the updated policies and procedures, for a total of 60 burden hours.[1474] We also estimate ten hours of outside counsel services will be required at a cost of $4,970 to review updated policies and procedures on behalf of a large broker-dealer.[1475] We therefore estimate the aggregate initial burden for large broker-dealers to be of 120,600 burden hours[1476] and initial aggregate cost of approximately $10.0 million for large broker-dealers.[1477]

For small broker-dealers, we believe that they 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. Given that smaller broker-dealers generally have fewer conflicts of interest, we estimate that 40 hours of outside legal counsel would be required to update existing policies and procedures, for a one-time cost of $19,880 per small broker-

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1474 This estimate is based on the following calculation: (50 hours of review for in-house counsel and in-house compliance counsel) + (5 hours of review for general counsel) + (5 hours of review for Chief Compliance Officer) = 60 initial burden hours per large broker-dealer.

1475 Data from the SIFMA Management and Professional Earnings Report suggests that the average hourly rate for legal services is $497/hour. This cost estimate is therefore based on the following calculation: (10 hours of review) x ($497/hour for outside counsel services) = $4,970 in outside counsel costs per large broker-dealer.

1476 This estimate is based on the following calculation: (60 burden hours of review per large broker-dealer) x (2,010 large broker-dealers) = 120,600 aggregate burden hours for large broker-dealers.

1477 This estimate is based on the following calculation: ($4,970 for outside counsel costs per large broker-dealer) x (2,010 large broker-dealers) = approximately $10.0 million in outside counsel costs for large broker-dealers.

dealer,[1478] and an aggregate cost of $15.0 million for all small broker-dealers.[1479] We also expect that in-house compliance would require 10 hours to review and approve the updated policies and procedures, for an aggregate burden of 7,560 hours.[1480] Therefore, we estimate the total initial aggregate burden to be 128,160 hours[1481] and the total initial aggregate cost to be approximately $25.0 million.[1482]

ii. Ongoing Costs and Burdens

For purposes of this analysis, we assume that small and large broker-dealers would review and update policies and procedures on an annual basis to accommodate the addition of, for example, 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

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[1478] This cost estimate is based on the following calculation: (40 hours of review) x ($497/hour for outside counsel services) = $19,880 in outside counsel costs per small broker-dealer.

[1479] This cost estimate is based on the following calculation: ($19,880 for outside attorney costs per small broker-dealer) x (756 small broker-dealers) = approximately $15.0 million in outside counsel costs for small broker-dealers.

[1480] This estimate is based on the following calculation: (10 burden hours) x (756 small broker-dealers) = 7,560 aggregate burden hours.

[1481] This estimate is based on the following calculation: (120,600 aggregate burden hours for large broker-dealers) + (7,560 aggregate burden hours for small broker-dealers) = 128,160 total aggregate burden hours.

[1482] This estimate is based on the following calculation: ($10 million in aggregate costs for large broker-dealers) + ($15.0 million in aggregate costs for small broker-dealers) = $25.0 million total aggregate costs.

compliance with the Conflict of Interest Obligation on an annual basis, and in-house personnel would perform the review and make any updates.

In the Proposing Release, we estimated that large broker-dealers would incur an annual internal burden of 12 hours to review and update existing policies and procedures to identify new conflicts for an ongoing, aggregate burden of 24,660 hours with no ongoing costs as they would rely on internal personnel.[1483] We assumed small broker-dealers would rely on outside legal counsel and compliance consultants to review and update policies and procedures, with final review and approval from in-house compliance[1484] with an aggregate, annual ongoing cost of $3.08 million per year.[1485] In addition to these costs, we believed that small broker-dealers would incur an internal an ongoing, aggregate burden of 28,670 hours. While the Commission believes our time estimates from the Proposing Release are generally accurate, we have revised our burdens and estimates to account for changes in both the number of broker-dealers and external costs of services.

We estimate that large broker-dealers, which generally have more numerous and complex products and services, as well as and higher rates of hiring and turnover would incur an annual internal burden of 12 hours to review and update existing policies and procedures: four hours for in-house counsel, four hours for in-house compliance, and four hours for business-line personnel

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1483 Proposing Release at 21667.

1484 *Id.*

1485 *Id.*

to identify new conflicts. We therefore estimate an ongoing, aggregate burden for large broker-dealers of approximately 24,120 hours.[1486] 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 external costs.

We assume for purposes of this analysis that small broker-dealers, generally have fewer and less complex products and lower rates of hiring. We also assume they would primarily 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 estimate that outside legal counsel would require approximately five hours per year to update policies and procedures, for an annual cost of $2,485 for each small broker-dealer.[1487] The projected aggregate, annual ongoing cost for outside legal counsel to update policies and procedures for small broker-dealers would be $1.88 million per year.[1488] In addition, we expect that small broker-dealers would require five hours of outside compliance services per year to

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1486 This estimate is based on the following calculation: (12 burden hours per large broker-dealer) x (2,010 large broker-dealers) = 24,120 aggregate ongoing burden hours.

1487 This estimate is based on the following calculation: (5 hours per small broker-dealer) x ($497/hour for outside counsel services) = $2,485 in outside counsel costs.

1488 This estimate is based on the following calculation: ($2,485 in outside counsel costs per small broker-dealer) x (756 small broker-dealers) = $1.88 million in aggregate, ongoing outside legal costs per year.

update their policies and procedures, for an ongoing cost of $1,365 per year,[1489] and an aggregate ongoing cost of $1.03 million.[1490] The total aggregate, ongoing cost for small broker-dealers is therefore projected at $2.91 million per year.[1491]

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 3,780 hours for in-house compliance manager review.[1492]

[1489] We believe that performance of this function will most likely be equally allocated between a senior compliance examiner and a compliance manager. Data from the SIFMA Management and Professional Earnings Report suggests that costs for these positions are $237 and $309 per hour, respectively for an average of $273 per hour. This cost estimate is based on the following calculation: (5 hours of review) x ($273/hour for outside compliance services) = $1,365 in outside compliance service costs.

[1490] This estimate is based on the following calculation: ($1,365 in outside compliance costs per small broker-dealer) x (756 small broker-dealers) = $1.03 million in aggregate, ongoing outside compliance costs per year.

[1491] This estimate is based on the following calculation: ($1.88 million for outside legal counsel costs) + ($1.03 million for outside compliance costs) = $2.91 million total aggregate ongoing costs per year.

[1492] This estimate is based on the following calculation: (5 hours compliance manager review per small broker-dealer) x (756 small broker-dealers) = 3,780 aggregate ongoing burden hours per year.

We therefore estimate the total ongoing aggregate ongoing burden to be 27,900 hours per year[1493] and the total ongoing aggregate cost to be $2.91 million per year.[1494]

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 expect that the need to update policies and procedures might also vary greatly.

b. Identification and Management of Conflicts of Interest

With respect to identifying and determining whether a conflict of interest exists in connection with a recommendation and whether it needs to be addressed through disclosure, mitigation and/or elimination, 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.[1495] For purposes of this analysis, we assume that most broker-dealers already have an existing technological infrastructure in place, and we assume it would need to be modified to comply with the Conflict of Interest Obligation.

1493 This estimate is based on the following calculation: (24,120 aggregate ongoing burden hours for large broker-dealers) + (3,780 aggregate ongoing burden hours for small broker-dealers) = 27,900 total aggregate ongoing burden hours per year.

1494 This estimate is based on the following calculation: ($2.91 million per year in total aggregate ongoing costs for small broker-dealers) + ($0 projected ongoing costs for large broker-dealers) = $2.91 million per year in total aggregate ongoing costs.

1495 *See supra* Section III.C.3.

i. Initial Costs and Burdens

As stated in the Proposing Release, we believed that costs and burdens may vary greatly depending on the size of the broker-dealer, but we expected that modification of a broker-dealer's existing technology would initially require the retention of an outside programmer as well as coordination between the programmer and the broker-dealer's in-house compliance manager. The costs and burdens for this process were estimated to be $15.43 million and 14,285 burden hours.[1496] In addition to these costs and burdens, we expected that a broker-dealer would spend time to determine whether the conflict of interest identified were material and would have required an additional 14,285 burden hours for all broker-dealers for an aggregate burden of 28,570 hours for identification of conflicts of interest.[1497]

As stated above, we believe the process would be largely the same as set forth in the Proposing Release but have revised our estimates and costs below to account for changes in the number of broker-dealers and external costs as well as to account for some changes to the structure of the Conflict of Interest Obligation.

To comply with the Conflict of Interest Obligation, we expect that broker-dealers will modify existing technology through the work of an outside programmer which would require, on

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1496 Proposing Release at 21667.

1497 *Id.*

average, an estimated 20 hours, for an estimated cost per broker-dealer of $5,680.[1498] We additionally continue to estimate (as was set forth in the Proposing Release) that coordination between the programmer and the broker-dealer's compliance manager would involve five burden hours.[1499] The aggregate initial costs and burdens for the modification of existing technology to identify conflicts of interest would therefore be $15.71 million,[1500] and 13,830 burden hours.[1501]

As a result of the changes made to the rule text of the Conflict of Interest Obligation, we believe that broker-dealers would incur burdens to: (1) identify conflicts of interest and determine whether the conflict involves an incentive to an associated person to place the interest of the broker-dealer or natural person making the recommendation ahead of the interest of the retail customer, a material limitation on the product menu, or a sales practice that is based on the sales of specific securities or specific types of securities within a limited period of time and (2) determine whether and how the conflict would be disclosed, disclosed and mitigated, or eliminated in accordance with the Conflict of Interest Obligation. In order to complete this

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1498 Data from the SIFMA Management and Professional Earnings Report suggests that the average hourly rate for technology services in the securities industry is $284. This cost estimate is based on the following calculation: (20 hours of review) x ($284/hour for technology services) = $5,680.

1500 This cost estimate is based on the following calculation: ($5,680 in outside programmer costs per broker-dealer) x (2,766 broker-dealers) = $15.71 million in aggregate outside programmer costs.

1501 This burden estimate is based on the following calculation: (5 burden hours for in-house compliance manager) x (2,766 broker-dealers) = 13,830 aggregate burden hours.

process, we believe a broker-dealer, on average, would require approximately 20 hours[1502] of review per broker-dealer,[1503] for an aggregate of 55,320 burden hours for all broker-dealers.[1504] We therefore estimate the total initial aggregate burden for identification and management of conflicts of interest is 69,150 hours.[1505]

ii. Ongoing Costs and Burdens

To maintain compliance with the Conflict of Interest Obligation, we assume for purposes of this analysis that a broker-dealer would seek to identify additional conflicts of interest as its business evolves. As noted above, the Commission recognizes that broker-dealers vary in the types of services and product offerings and therefore vary in the types of conflicts of interest that exist within and across broker-dealers.[1506]

However, for purposes of the PRA analysis in the Proposing Release, we assumed that broker-dealers would, at a minimum, engage in a material conflicts identification process on an annual basis, and we estimated that in the aggregate broker-dealers would spend approximately

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1502 In light of the changes made to the rule text of the Conflict of Interest Obligation and the comments received, we have increased our estimate to 20 burden hours per broker-dealer.

1503 This burden estimate consists of 10 hours for review by business line personnel, and 10 hours for review by in-house compliance manager.

1504 This burden estimate is based on the following calculation: (20 burden hours) x (2,766 broker-dealers) = 55,320 aggregate burden hours.

1505 This burden estimate is based on the following calculation: (13,830 burden hours for modification of technology) + (55,320 burden hours for evaluation of managing conflicts) = 69,150 total aggregate burden hours.

1506 *See supra* Section II.C.3.

28,570 hours each to complete this process per year.[1507] Similar to the Proposing Release, we believe that for purposes of this analysis, broker-dealers would, through the help of the business line and compliance personnel, spend on average 10 hours[1508] to perform an annual conflicts review using the modified technology infrastructure.[1509] Therefore, the Commission estimates that the aggregate ongoing burden for an annual conflicts review, based on an estimated 2,766 retail broker-dealers, would be approximately 27,660 burden hours per year.[1510] Because we assume that broker-dealers would use in-house personnel to identify and evaluate new, potential conflicts, we continue to believe they would not incur additional ongoing external costs.

c. Training

As discussed in the Proposing Release, we expect that broker-dealers would develop training programs to comply with Regulation Best Interest, including the Conflict of Interest Obligation. However, we believe that any burdens and costs associated with a training program

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1507 *See* Proposing Release at 21668.

1508 This burden estimate consists of five hours for review by business line personnel, and five hours for review by an in-house compliance manager.

1509 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).

1510 This estimate is based on the following calculation: (10 hours per retail broker-dealer) x (2,766 retail broker-dealers) = 27,660 aggregate burden hours per year.

would fall under the new Compliance Obligation as it would be developed to comply with Regulation Best Interest as a whole, including each of the component obligations.

In total, to comply with the Conflict of Interest Obligation, the Commission estimates that the total initial burdens and costs to be 197,310 hours[1511] and $40.71 million,[1512] and the total ongoing burdens and costs to be 55,560 hours[1513] per year and $2.91 million per year.[1514]

4. Compliance Obligation

As discussed above, in response to comments that we should require policies and procedures to comply with Regulation Best Interest as a whole, we are adopting the Compliance Obligation.[1515] The Compliance Obligation requires that the broker-dealer[1516] establish,

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1511 This estimate is based on the following calculation: (128,160 initial burden hours for policies and procedures) + (69,150 initial burden hours for identification and management of conflicts of interest) = 197,310 initial burden hours to comply with the Conflict of Interest Obligation.

1512 This estimate is based on the following calculation: ($25.0 million initial costs for policies and procedures) + ($15.71 million initial costs for identification and management of conflicts of interest) =$40.71 million initial total costs to comply with the Conflict of Interest Obligation.

1513 This estimate is based on the following calculation: (27,900 ongoing burden hours for policies and procedures) + (27,660 ongoing burden hours for identification and management of conflicts of interest) = 55,560 aggregate ongoing burden hours per year to comply with Conflict of Interest Obligation.

1514 This estimate is based on the following calculation: ($2.91 million ongoing costs for policies and procedures) + ($0 ongoing costs for identification and management of conflicts of interest) = $2.91 million aggregate ongoing total costs per year to comply with the Conflict of Interest Obligation.

1515 Section II.C.4.

maintain and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest. This Compliance Obligation creates an explicit obligation under the Exchange Act with respect to Regulation Best Interest as a whole. Similar to the policies and procedures requirement of the Conflict of Interest Obligation, broker-dealers will have flexibility to design policies and procedures that are reasonable for the scope, size and risks associated with the operations of the firm and the types of business in which the broker-dealer engages. Because we did not include the Compliance Obligation in the Proposing Release, we did not previously include costs and burdens associated with the Compliance Obligation, but we have provided a detailed explanation of these costs and burdens below.[1517]

a. Written Policies and Procedures

i. Initial Costs and Burdens

While the Compliance Obligation creates an explicit requirement under the Exchange Act, we believe that broker-dealers would likely establish policies and procedures to comply with Regulation Best Interest pursuant to Section 15(b)(4)(E) and SRO rules by adjusting their current systems of supervision and compliance, as opposed to creating new systems. While broker-dealers must already have policies and procedures in place to address other Commission and

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1516 *See supra* footnote 1463 and accompanying text.

1517 We note that any burdens and costs to comply with the Conflict of Interest Obligation are included in the estimates in Section IV.B.3 above.

SRO rules, they would need to update their systems of supervision and compliance to account for Regulation Best Interest.

To comply with the Compliance 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 to account for the Disclosure and Care Obligations.[1518] 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 employ more individuals and therefore would need to evaluate and update a greater number of systems. As discussed above, we estimate that 2,010 broker-dealers would qualify as large broker-dealers for purposes of this analysis and 756 would qualify as small broker-dealers that have retail business.[1519]

For purposes of this analysis we estimate that a large broker-dealer would incur a one-time average internal burden of 30 hours for in-house legal personnel and in-house compliance counsel to update existing policies and procedures to comply with the Compliance Obligation and a one-time burden of five hours for general counsel and five hours for a Chief Compliance Officer to review and approve the updated policies and procedures, for a total of 40 burden

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1518 *Id.*

1519 *See supra* footnote 1388 and accompanying text.

hours.[1520] We also estimate six hours of outside counsel services a cost of $2,982 for outside counsel to review updated policies and procedures on behalf of a large broker-dealer.[1521] We therefore estimate the aggregate burden for large broker-dealers to be of 80,400 burden hours[1522] and aggregate cost of $6.0 million for large broker-dealers.[1523]

For small broker-dealers, we believe that they 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. We estimate that only 20 hours of outside legal counsel services would be required, for a one-time cost of $9,940 per small broker-dealer,[1524] and an aggregate cost of $7.5 million for all small broker-dealers.[1525] We also expect that in-house

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1520 This estimate is based on the following calculation: (30 hours of review for in-house legal and in-house compliance) + (5 hours of review for general counsel) + (5 hours of review for Chief Compliance Officer) = 40 burden hours.

1521 Data from the SIFMA Management and Professional Earnings Report suggests that the average hourly rate for legal services is $497/hour. This cost estimate is therefore based on the following calculation: (6 hours of review) x ($497/hour for outside counsel services) = $2,982 in outside counsel costs.

1522 This estimate is based on the following calculation: (40 burden hours of review per large broker-dealer) x (2,010 large broker-dealers) = 80,400 aggregate burden hours.

1523 This estimate is based on the following calculation: ($2,982 for outside counsel costs per large broker-dealer) x (2,010 large broker-dealers) = $6.0 million in outside counsel costs.

1524 This cost estimate is based on the following calculation: (20 hours of review) x ($497/hour for outside counsel services) = $9,940 in outside counsel costs.

1525 This cost estimate is based on the following calculation: ($9,940 for outside counsel costs per small broker-dealer) x (756 small broker-dealers) = $7.5 million in outside counsel costs.

compliance personnel would require 6 hours to review and approve the updated policies and procedures, for an aggregate burden of 4,536 hours.[1526] Therefore, we estimate the total initial aggregate burden to be 84,936 hours[1527] and the total initial aggregate cost to be $13.5 million.[1528]

ii. Ongoing Costs and Burdens

For purposes of this analysis, we assume 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 for purposes of this analysis, we assume they would perform the review and update using in-house personnel. Under the Compliance Obligation, we do not believe that broker-dealers would incur any costs or burdens associated with compliance with the Conflict of Interest Obligation, as those are included in the discussion above, but would for ongoing compliance with the Disclosure and Care Obligations.

1526 This estimate is based on the following calculation: (6 burden hours) x (756 small broker-dealers) = 4,536 initial aggregate burden hours.

1527 This estimate is based on the following calculation: (80,400 aggregate burden hours for large broker-dealers) + (4,536 aggregate burden hours for small broker-dealers) = 84,936 total initial aggregate burden hours.

1528 This estimate is based on the following calculation: ($6 million in aggregate costs for large broker-dealers) + ($7.5 million in aggregate costs for small broker-dealers) = $13.5 million total initial aggregate costs.

For large broker-dealers with more numerous and complex products and services, as well as 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. We therefore estimate an ongoing, aggregate burden for large broker-dealers of approximately 24,120 hours per year.[1529]

We assume for purposes of this analysis that small broker-dealers, who generally have fewer and less complex products, and lower rates of hiring and turnover, would mostly rely on outside legal counsel and compliance consultants for review and update of their policies and procedures, with final review and approval from an in-house compliance manager. We estimate that outside counsel would require approximately five hours per year to update policies and procedures, for an annual cost of $2,485 for each small broker-dealer.[1530] The projected aggregate, annual ongoing cost for outside legal counsel to update policies and procedures for

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[1529] This estimate is based on the following calculation: (12 burden hours per large broker-dealer) x (2,010 large broker-dealers) = 24,120 aggregate ongoing burden hours per year.

[1530] Data from the SIFMA Management and Professional Earnings Report suggests that the average hourly rate for legal services is $497/hour. This estimate is therefore based on the following calculation: (5 hours per small broker-dealer) x ($497/hour for outside counsel services) = $2,485 in outside counsel costs per year.

small broker-dealers would be $1.88 million.[1531] In addition, we expect that small broker-dealers would require five hours of outside compliance services per year to update their policies and procedures, for an ongoing cost of $1,365 per year,[1532] and an aggregate ongoing cost of $1.03 million.[1533] The Commission estimates the total aggregate, ongoing cost for small broker-dealers is therefore $2.91 million per year.[1534]

b. Training

Pursuant to the Compliance Obligation's requirement to "maintain and enforce" written policies and procedures, we additionally believe broker-dealers will develop training programs that promote compliance with Regulation Best Interest. We believe that a training program would cover compliance with Regulation Best Interest as a whole and would therefore cover the

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1531 This estimate is based on the following calculation: ($2,485 in outside counsel costs per small broker-dealer) x (756 small broker-dealers) = $1.88 million in aggregate, ongoing legal costs per year.

1532 We believe that performance of this function will most likely be equally allocated between a senior compliance examiner and a compliance manager. Data from the SIFMA Management and Professional Earnings Report suggests that costs for these positions are $237 and $309 per hour, respectively for an average of $273 per hour. This estimate is therefore based on the following calculation: (5 hours per small broker-dealer) x ($273/hour for outside counsel services) = $1,365 in outside compliance service costs per year.

1533 This estimate is based on the following calculation: ($1,365 in outside compliance costs per small broker-dealer) x (756 small broker-dealers) = $1.03 million in aggregate, ongoing outside compliance costs per year.

1534 This estimate is based on the following calculation: ($1.88 million for outside legal counsel costs) + ($1.03 million for outside compliance costs) = $2.91 million total aggregate ongoing costs per year.

Disclosure, Care and Conflict of Interest Obligations. The initial and ongoing costs and burdens associated with such a training program are estimated below.

i. Initial Costs and Burdens

We believe that broker-dealers would likely use a computerized training model to train their associated persons regarding the policies and procedures pertaining to Regulation Best Interest. We estimate that a broker-dealer would retain an outside systems analyst, outside programmer, and an outside programmer analyst to create the training module, at 20 hours, 40 hours, and 20 hours, respectively. The total cost to develop the training module would be approximately $20,920,[1535] for an aggregate initial cost of $62.8 million.[1536]

Additionally, we expect that the training module would require the approval of the Chief Compliance Officer, as well as in-house counsel, each of whom would require approximately 2

[1535] Data from the SIFMA Management and Professional Earnings Report suggests that the average hourly rate in the securities industry is $263 for a systems analyst, $271 for a programmer, and $241 for a programmer analyst.. This cost estimate is based on the following calculation: ((20 hours for a systems analyst) x ($263/ hour)) + ((40 hours of labor for a programmer) x ($271/hour)) + ((20 hours of labor for a programmer analyst) x ($241/hour)) = $20,920 in external technology costs per broker-dealer.

[1536] This estimate is based on the following calculation: (2,766 broker-dealers) x ($20,920in external technology costs per broker-dealer) = $57.9 million in aggregate costs for technology services

hours to review and approve the training module. The initial aggregate burden for broker-dealers is therefore estimated at 11,064 burden hours.[1537]

In addition, broker-dealers would incur an initial cost for associated persons to undergo training through the training module. We estimate the training time at one hour per associated person, for an aggregate burden of 428,404 burden hours, or an initial burden of 154.9 hours per broker-dealer.[1538] We estimate the total initial aggregate burden to approve the training module and implement the training program would be 439,486 burden hours.[1539]

ii. 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 428,404 burden hours per year, or 154.9 burden hours per broker-dealer per year.[1540]

1537 This estimate is based on the following calculation: (2,766 broker-dealers) x (4 burden hours per broker-dealer) = 11,064 burden hours.

1538 This estimate is based on the following calculation: (1 burden hour) x (428,404 registered representatives at standalone or dually registered broker-dealers) = 428,404 aggregate burden hours. Conversely, (428,404 aggregate burden hours) / (2,766 retail broker-dealers) = 154.9 initial burden hours per broker-dealer per year.

1539 This estimate is based on the following calculation: (428,404 burden hours for training of registered representatives) + (11,064 burden hours to approve training program) = 439,468 total aggregate burden hours per year.

1540 This estimate is based on the following calculation: (1 burden hour) x (428,404 registered representatives at standalone or dually registered broker-dealers) = 428,404 burden hours.

In total, to comply with the Compliance Obligation, the Commission estimates the total initial burdens and costs to be 524,414 hours[1541] and $71.4 million,[1542] and the total ongoing burdens and costs to be 463,588 hours[1543] and $2.91 million.[1544]

5. Record-Making and Recordkeeping Obligations

The record-making and recordkeeping obligations will impose record-making and recordkeeping requirements on broker-dealers with respect to certain information collected from, or provided to, retail customers. Specifically, the Commission is amending Rules 17a-3 and 17a-4 of the Exchange Act, which set forth minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents must be kept, respectively. Records made and retained in accordance with the amendments to Rule 17a-3(a)(35) and 17a-4(e)(5) will (1) assist a broker-dealer in supervising and assessing internal

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Conversely, (428,404 aggregate burden hours) / (2,766 retail broker-dealers) = 154.9 initial burden hours per broker-dealer.

1541 This estimate is based on the following calculation: (84,946 initial burden hours for policies and procedures) + (439,468 initial burden hours training) = 524,414 initial burden hours to comply with the Compliance Obligation.

1542 This estimate is based on the following calculation: ($13.5 million initial costs for policies and procedures) + ($57.9 million initial costs for training) = $71.4 million initial total costs to comply with the Compliance Obligation.

1543 This estimate is based on the following calculation: (24,120 ongoing burden hours for policies and procedures) + (439,468 ongoing burden hours for training) = 463,588 ongoing burden hours to comply with Compliance Obligation.

1544 This estimate is based on the following calculation: ($2.91 million ongoing costs for policies and procedures) + ($0 million ongoing costs for training) = $2.91 million ongoing costs to comply with the Compliance Obligation.

compliance with Regulation Best Interest; and (2) assist the Commission and SRO staff in connection with examinations and investigations.

Due to changes in the number of broker-dealers and costs estimated for certain services, we are revising our estimates from those in the Proposing Release. However, while we understand commenters' concerns that the estimates are lower than what would actually be required to comply with Regulation Best Interest, we believe the estimates are generally accurate in light of the increased specificity in Regulation Best Interest on how to comply with the component obligations, including the Disclosure Obligation.[1545] The record-making and recordkeeping costs and burdens associated with the amendments to Rule 17a-3(a)(35) and Rule 17a-4(e)(5) are addressed below.

a. Record-Making Obligation

We are amending Rule 17a-3 by adding a new paragraph (a)(35) that requires 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.[1546] This requirement applies with respect to each

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1545 *See, e.g.,* Raymond James Letter; CCMC Letters; SIFMA August 2018 Letter.

1546 As indicated in the Proposing Release, 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). We continue to believe, for purposes of compliance with Rule 17a-3(a)(35), that broker-dealers would need to create a record, or modify an existing record,

retail customer to whom a recommendation of any securities transaction or investment strategy involving securities is provided. The neglect, refusal, or inability of a retail customer to provide or update any such information will, however, excuse the broker-dealer from obtaining that information.

We indicated in the Proposing Release, and we continue to believe 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.[1547] In addition, we continue to believe that broker-dealers likely make records of the "identity of each natural person who is an associated person, if any, responsible for the account." However, we are assuming, for purposes of compliance with Rule 17a-3(a)(35), that broker-dealers will need to create a record, or modify an existing record, to identify the associated person, if any,

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to identify the associated person, if any, responsible for the account in the context of Regulation Best Interest. *See* Proposing Release at 21673.

1547 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 Regulation Best Interest and the Relationship Summary Adopting Release. With respect to the requirement that a record be made of all information *from* the retail customer, we believe that Rule 17a-3(a)(35) will not impose any new substantive burdens on broker-dealers. As discussed above, we continue to believe that the obligation to exercise reasonable diligence, care, and skill will 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 resulting recommendations will need to adhere to the enhanced best interest standard of Regulation Best Interest. *See supra* Section II.C.2.

responsible for the account in the context of Regulation Best Interest. In addition, in cases where broker-dealers choose to meet part of the Disclosure Obligation orally under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*, we believe the requirement to maintain a record of the fact that oral disclosure was provided to the retail customer will trigger a record-making obligation under paragraph (a)(35) of Rule 17a-3 and a recordkeeping obligation under paragraph (e)(5) of Rule 17a-4 that may impose additional compliance costs and burdens on broker-dealers.

i. Initial Costs and Burdens

In the Proposing Release, we assumed 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 the "identity of each natural person who is an associated person, if any, responsible for the account." We estimated that the inclusion of this information in an account disclosure document would require an approximate total aggregate initial burden of 3,808,000 hours, or approximately 1,333 hours per broker-dealer for the first year after Regulation Best Interest is in effect.[1548]

[1548] These estimates were based on the following calculations: (0.04 hours per customer account) x (95.2 million retail customer accounts) = 3,808,000 aggregate burden hours. Conversely, (3,808,000 aggregate burden hours) / (2,857 broker-dealers) = 1,333 hours per broker dealer for the first year after Regulation Best Interest is in effect. *See* Proposing Release at 21673.

As discussed above, we continue to believe that broker-dealers will satisfy the record-making requirements of the amendment to Rule 17a-3(a)(35) by amending an existing account disclosure document to include the "identity of each natural person who is an associated person, if any, responsible for the account." We believe that the inclusion of this information in an account disclosure document will require, on average, approximately 1 hour per year for outside legal counsel at small broker-dealers, at an updated average rate of $497/hour, for an average annual cost of $497 for each small broker-dealer to update an account disclosure document. The projected aggregate initial cost for small broker-dealers is therefore estimated to be $375,732 per year.[1549] For broker-dealers that are not small entities, we estimate that the initial burden will be 2 hours for each broker-dealer: 1 hour for compliance personnel and 1 hour for legal personnel. We therefore estimate the aggregate initial burden for broker-dealers that are not small entities to be approximately 4,020 burden hours.[1550] Finally, we estimate it will 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 4,080,000 hours, or approximately 1,475 hours per broker-dealer

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[1549] This estimate is based on the following calculation: (1 hour per small broker-dealer) x (756 small broker-dealers) x ($497/hour) = $375,732 in aggregate costs per year.

[1550] This estimate is based on the following calculation: (2 burden hours per broker-dealer) x (2,010 large broker-dealers) = 4,020 aggregate burden hours per year.

for the first year after Regulation Best Interest is in effect.[1551] Because we have already included the costs and burdens associated with the creation of a record to memorialize an oral disclosure, and the delivery of the amended account disclosure document discussed above, they are not included in this section of the analysis.[1552]

The total aggregate initial burden for broker-dealers is therefore estimated at 4,084,020 hours,[1553] and the total aggregate initial cost is estimated at $375,732.[1554]

ii. Ongoing Costs and Burdens

We do not believe that the identity of the registered representative responsible for the retail customer's account will change. Accordingly, we continue to believe that there are no ongoing costs and burdens associated with this record-making requirement of the amendment to Rule 17a-3(a)(35).

1551 These estimates are based on the following calculations: (0.04 hours per customer account) x (102 million retail customer accounts) = 4,080,000 aggregate burden hours. Conversely, (4,080,000 burden hours) / (2,766 broker-dealers) = 1,475 hours per broker-dealer for the first year after Regulation Best Interest is in effect.

1552 *See supra* Section IV.B.1.

1553 This estimate is based on the following calculation: (0 aggregate burden hours for small broker-dealers) + (4,020 burden hours for large broker-dealers) + (4,080,000 burden hours for personnel to fill out information in the account disclosure document) = 4,080,000 initial burden hours.

1554 This estimate is based on the following calculation: ($375,732 for small broker-dealer costs) + ($0 for large broker-dealer costs) = ($375,732 in total aggregate initial costs).

With respect to memorializing oral disclosures in cases where broker-dealers choose to meet part of the Disclosure Obligation orally under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*, we estimate that this would take place among 52% of a broker-dealer's retail customer accounts (and thus 52% of a registered representative's retail customer accounts) annually.[1555] We therefore estimate broker-dealers to incur a total annual aggregate burden of 1.06 million hours, or 383.5 burden hours per year per broker-dealer.[1556]

b. Recordkeeping Obligation

We are amending Rule 17a-4(e)(5) to require that broker-dealers retain all records of the information collected from or provided to each retail customer pursuant to Regulation Best

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[1555] We believe (and our experience indicates) that broker-dealers will use oral disclosure rarely, and primarily when making disclosures regarding a change in capacity. We do not have reliable data to determine the precise number of retail customers that have both a brokerage and an advisory account with a dually registered associated person. As indicated above, approximately 52% of registered representatives were dually registered as investment adviser representatives at the end of 2018. *See supra* footnote 945 and accompanying text. As a result, we have assumed for purposes of this analysis that this will take place among 52% of all retail customer accounts at broker-dealers annually. This estimate is likely over inclusive, as it includes all retail customer accounts at all broker-dealers (as opposed to only retail customer accounts where the retail customer has both a brokerage and advisory account with a dually registered financial professional), and under inclusive, as it assumes that such an oral disclosure will happen annually (as opposed to multiple times a year).

[1556] (52%) x (102 million retail customer accounts) x (0.02 hours for recording each oral disclosure relating to a retail customer's account) = 1,060,800 aggregate burden hours. Conversely, 1,060,800 aggregate burden hours / 2,766 broker-dealers = 383.5 burden hours per broker-dealer per year.

Interest for at least six years after the earlier of the date the account was closed or the date on which the information was last replaced or updated. We assume that, for purposes of this analysis, the following records would likely be retained pursuant to amended Rule 17a-3(a)(35): (1) existing account disclosure documents; (2) comprehensive fee schedules; (3) disclosures identifying material conflicts; and (4) memorialized oral disclosures under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*.[1557]

i. Initial Costs and Burdens

We believe that, to reduce costs and for ease of compliance, broker-dealers will 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 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

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[1557] In the Proposing Release, we identified four records that would likely need to be retained pursuant to amended Rule 17a-3(a)(25) (now reflected as Rule 17a-3(a)(35)): (1) a standardized Relationship Summary document; (2) existing account disclosure documents; (3) a comprehensive fee schedule; and (4) disclosures identifying material conflicts. However, in calculating the estimated burden for broker-dealers to add new documents or modify existing documents to the broker-dealer's existing retention system, we erroneously assumed a broker-dealer would upload or file *five* account documents, as opposed to the *four* account documents identified in the Proposing Release. *See* Proposing Release at 21673-21674. In addition, while the burden for broker-dealers to retain a standardized relationship summary was included in the Regulation Best Interest Proposing Release, it is excluded here because its associated burden is reflected in the Relationship Summary Proposal and Relationship Summary Adopting Release.

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, broker-dealers are already required to maintain documents such as account blotters and ledgers for six years.

We continue to believe that broker-dealers will utilize their existing recordkeeping systems to include any additional or amended records required by Regulation Best Interest or pursuant to the amendment to Rule 17a-4(e)(5), and would similarly utilize 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 continue to expect broker-dealers to maintain any additional documents required by Regulation Best Interest or the 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 our belief that broker-dealers will rely on existing infrastructures to satisfy the recordkeeping obligations of Regulation Best Interest and the amendment to Rule 17-a(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 will be approximately 13.6 million burden hours for all broker-dealers, assuming a broker-dealer will need to upload or file each of the four account

documents discussed above for each retail customer account.[1558] We do not believe there will be additional substantive internal or external costs relating to the uploading or filing of the documents. 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.

ii. Ongoing Costs and Burdens

We estimate that the approximate ongoing burden associated with the recordkeeping requirement of the amendment to Rule 17a-4(e)(5) is 4.46 million burden hours per year.[1559] We

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[1558] This estimate is based on the following calculation: (4 documents per customer account) x (102 million retail customer accounts) x (2 minutes per document) / 60 minutes = 13,600,000 aggregate burden hours. As indicated above, the following records would likely need to be retained: (1) existing account disclosure documents; (2) comprehensive fee schedules; (3) disclosures identifying material conflicts; and (4) memorialized oral disclosures under the circumstances outlined in Section II.C.1, Disclosure Obligation, *Oral Disclosure or Disclosure After a Recommendation*.

[1559] This estimate is based on the percentage of account records we expect would be updated each year as described in Section IV.B.1, *supra,* and the following calculation: (40% of fee schedules x 102 million retail customer accounts) x (2 minutes per document) + (40% of conflict disclosure forms x 102 million retail customer accounts) x (2 minutes per document) + (20% of account opening documents x 102 million retail customer accounts) x (2 minutes per document) = 204 million minutes / 60 minutes = 3.4 million aggregate ongoing burden hours. In addition, with respect to ongoing memorialization of the updated oral disclosures, we estimate that this will take place among 52% of a broker-dealer's retail customer accounts annually. We therefore estimate that broker-dealers will incur an aggregate ongoing burden of 1.06 million hours per year (calculated as follows: (52% of updated oral disclosures x 102 million retail customer accounts) x (1.2 minutes per document) = 63.6 million minutes / 60 minutes = 1.06 million aggregate ongoing burden hours); or 383.5 burden hours per broker-dealer (1.06 million hours / 2,766

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.

V. FINAL REGULATORY FLEXIBILITY ACT ANALYSIS

The Commission has prepared this Final Regulatory Flexibility Analysis ("FRFA") in accordance with the provisions of the Regulatory Flexibility Act ("RFA")[1560] relating to Regulation Best Interest. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with the RFA and included in the Proposing Release.[1561]

A. Need for and Objectives of the Rule

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.

As discussed in Section I, concerns exist regarding: (1) the potential harm to retail customers resulting from broker-dealer recommendations provided in the presence of conflicts of interest and (2) the insufficiency of existing broker-dealer regulatory requirements to address these conflicts when broker-dealers make recommendations to retail customers. More

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broker-dealers = 383.5). 3.4 million burden hours per year + 1.06 million burden hours per year = 4,460,000 total aggregate ongoing burden hours per year.

1560 5 U.S.C. § 603.

1561 *See* Proposing Release, *supra* footnote 7, at Section VII.

specifically, there are concerns that existing requirements do not require a broker-dealer's recommendations to be in the retail customer's best interest.

As a result, we are adopting Regulation Best Interest, which creates an enhanced standard of conduct applicable to broker-dealers at the time they recommend to a retail customer a securities transaction or investment strategy involving securities. This includes recommendations of account types and rollovers or transfers of assets and also covers implicit hold recommendations, resulting from agreed-upon account monitoring. When making a recommendation, a broker-dealer must act in the retail customer's best interest and cannot place its own interests ahead of the customer's interests. This General Obligation is satisfied only if the broker-dealer complies with four specified component obligations: (1) Disclosure Obligation, (2) Care Obligation, (3) Conflict of Interest Obligation, and (4) Compliance Obligation. In addition, the Commission is amending Rules 17a-3 and 17a-4 of the Exchange Act, which set forth minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents must be kept, respectively.

First, as described in Section II.C.1, under the Disclosure Obligation, before or at the time of making a recommendation, a broker-dealer must disclose, in writing,[1562] material facts about the scope and terms of its relationship with the customer. This includes a disclosure that

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[1562] As discussed above, there are circumstances where broker-dealers and their associated persons may make oral disclosures or written disclosures after the time of a recommendation under the circumstances outlined in Section II.C.1, Disclosure Obligation, *Oral Disclosure or Disclosure After a Recommendation*.

the broker-dealer or associated person is acting in a broker-dealer capacity; the material fees and costs the customer will incur; and the type and scope of the services to be provided, including any material limitations on the recommendations that could be made to the retail customer. Moreover, the broker-dealer must disclose all material facts relating to conflicts of interest associated with the recommendation that might incline a broker-dealer to make a recommendation that is not disinterested, including, for example, proprietary products, payments from third parties, and compensation arrangements.

Second, as described in Section II.C.2, under the Care Obligation, a broker-dealer must 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 those risks, rewards, and costs in light of the retail customer's investment profile and have a reasonable basis to believe that the recommendation is in the customer's best interest and does not place the broker-dealer's interest ahead of the retail customer's interest. When recommending a series of transactions, the broker-dealer must have a reasonable basis to believe that the transactions taken together are not excessive, even if each is in the retail customer's best interest when viewed in isolation.

Third, as described in Section II.C.3, under the Conflict of Interest Obligation, a broker-dealer must establish, maintain, and enforce reasonably designed written policies and procedures addressing conflicts of interest associated with its recommendations to retail customers. These policies and procedures must be reasonably designed to identify all such conflicts and at a minimum disclose or eliminate them. Additionally, the policies and procedures must be reasonably designed to mitigate conflicts of interests that create an incentive for an associated person of the broker-dealer to place its interests or the interest of the firm ahead of the retail

customer's interest. Moreover, when a broker-dealer places material limitations on recommendations that may be made to a retail customer (e.g., offering only proprietary or other limited range of products), the policies and procedures must be reasonably designed to disclose the limitations and associated conflicts and to prevent the limitations from causing the associated person or broker-dealer to place the associated person's or broker-dealer's interests ahead of the customer's interest. Finally, the policies and procedures must be reasonably designed to identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.

Fourth, as described in Section II.C.4, under the Compliance Obligation, a broker-dealer must also establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest as a whole. Thus, a broker-dealer's policies and procedures must address not only conflicts of interest but also compliance with its Disclosure and Care Obligations under Regulation Best Interest.

The enhancements contained in Regulation Best Interest will improve investor protection by enhancing the quality of broker-dealer recommendations to retail customers and reducing the potential harm to retail customers that may be caused by conflicts of interest. Regulation Best Interest will complement the related rules, interpretations, and guidance that the Commission is

concurrently issuing.[1563] Individually and collectively, these actions are designed to help retail customers better understand and compare the services offered by broker-dealers and investment advisers and make an informed choice of the relationship best suited to their needs and circumstances, provide clarity with respect to the standards of conduct applicable to investment advisers and broker-dealers, and foster greater consistency in the level of protections provided by each regime, particularly at the point in time that a recommendation is made.

All of these requirements are discussed in detail in Section II above. The costs and burdens of these requirements on small broker-dealers are discussed below as well as above in our Economic Analysis and PRA Analysis, that discuss the costs and burdens on all broker-dealers.

B. Significant Issues Raised by Public Comments

The Commission is sensitive to the burdens that the new rule may have on small entities. In the Proposing Release, we requested comment on matters discussed in the IRFA. In particular, we sought comments on the number of small entities that may be affected by proposed Regulation Best Interest, and whether proposed Regulation Best Interest would have an effect on small entities that had not been considered. We requested that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact. We

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[1563] *See* Relationship Summary Adopting Release; Fiduciary Interpretation; Solely Incidental Interpretation.

also requested comment on the proposed compliance burdens and the effects these burdens would have on smaller entities.

As discussed in the Economic Analysis and PRA Analysis above, we received comments regarding the potential costs and burdens of the proposal on broker-dealers, including those that are small entities.[1564] Additionally, the Commission received some comments specifically addressing the costs to smaller broker-dealers.

One commenter stated that for a small firm with $500,000 in net capital, a compliance cost of $60,000[1565] could constitute 12% of that net capital, making compliance with the rule burdensome for such firms and potentially forcing many small firms to hire additional compliance personnel.[1566] Another commenter raised concerns that replacing the term "suitable"

1564 *See supra* Sections III and IV.

1565 *See* NSCP Letter ("Consider the estimated $60,000 in additional compliance costs referenced in the Release which would represent 12% of net capital of a $500,000 firm.")

1566 *See id* ("Several small firms estimate that they incur approximately $80,000 in compliance costs to meet basic ongoing regulatory requirements. Notably, this amount does not include expenses associated with new rules, regulatory changes, regulatory exams or running a compliance department. In isolation, it may seem that this single proposal by one regulatory agency would have manageable marginal impact on costs. But in fact, it would be one of many changes (and importantly, a major change) that smaller firms must address. Many small firms do not have large Compliance Departments adequate to shoulder these ever increasing regulatory demands. In fact, many small firm Compliance Departments are comprised of just one or two persons."). *See also, generally*, NFIB Letter ("America's small and independent businesses in the financial industry cannot afford the army of lawyers and clerks needed to comply with the welter of complex rules issued or proposed by the U.S. Department of Labor (DOL) (Reference 1 above), the U.S. Securities and Exchange Commission (SEC) (Reference 2 above), and

with "best interest" could create legal risk and cause smaller and mid-sized professional firms to leave the market.[1567] As noted above in Section III, we acknowledge that the costs of the rule could be more burdensome for small firms and discuss any corresponding competitive effects in Section III.D.1.[1568] Further, as described above, we acknowledge the requests by commenters for further clarity on what it means to "act in the best interest" of the retail customer, and particularly what it means to make a recommendation in a retail customer's "best interest" under the Care Obligation. Consequently, in Section II.A, and in the detailed discussion of each of the Disclosure, Care, Conflict of Interest, and Compliance Obligations in Section II.C, we have provided further clarity on how a broker-dealer can comply with Regulation Best Interest.

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the several states to govern the duties of financial businesses toward their retail customers.")

1567 *See* Iowa Insurance Commissioner Letter ("Striking "suitability," and its history and legal precedence, will usher in an age of legal and marketing confusion. Additionally, smaller and mid-sized professional firms, to avoid the risks of this confusion and the resulting litigation, will leave the market, and the larger firms will remain, increasing market concentration. A decision to replace the term "suitable" in the text of traditional suitability rules with the phrase "best interest" will disrupt the market, decrease competition, increase the price of services out of the reach of thousands of middle class Americans, and significantly reduce consumer options for selecting valuable professional services.") *But see* NAIFA Letter ("NAIFA supports a best interest standard of conduct for securities-licensed firms and individuals, and we appreciate the SEC's considerable efforts to establish such a standard *without* imposing unduly prescriptive or burdensome implementation or compliance requirements. The SEC's general approach, we believe, will preserve choices for consumers at all income levels and account sizes – and should not unnecessarily increase costs for consumers or businesses.")

1568 *See also* infra Section V.E., noting that we believe that Regulation Best Interest will 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.

However, with respect to the comment concerning the term "suitable," we are adopting a "best interest" standard as proposed—which enhances the broker-dealer standard of conduct beyond existing suitability obligations—in light of our goal to enhance retail investor protection and decision making.

Another commenter stated that costs for small broker-dealers could be reduced if the Commission approved a standard disclosure, which would add certainty and reduce costs for small firms and their customers.[1569] We considered, as an alternative to the Disclosure Obligation, mandating a standardized disclosure.[1570] However, as described in Section II.C.1, after careful consideration of the comments concerning the proposed Disclosure Obligation, we have decided not to require any standard written disclosures under Regulation Best Interest at this time. We recognize the wide variety of business models and practices and we continue to believe it is important to provide broker-dealers with flexibility to enable them to better tailor disclosure and information that their retail customers can understand and may be more likely to

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1569 *See* Chepucavage Letter ("Costs for the small bd's however can be reduced with a commission approved standard disclosure which would add certainty and ought to be considered especially for the small investor. […] A standard disclosure document would also be useful for the small bd that cannot afford the legal assistance needed to evaluate this 1,000 page proposal and draft appropriate documents. […] The Commission should therefore reconsider the impact of its proposal on small investors and small bd's with the assumption that retirement accounts are significantly more important than regular brokerage accounts especially for small and elderly investors. A standard disclosure for small firms would reduce costs for the firms and their customers.")

1570 *See supra* Section III.E and *infra* Section V.E.

read at relevant points in time, rather than, for example, mandating a standardized all-inclusive (and likely lengthy) disclosure.

The vast majority of commenters supported the Commission's rulemaking efforts to address the standards of conduct that apply to broker-dealers when making recommendations, but nearly all commenters suggested modifications to proposed Regulation Best Interest. These suggestions touch on almost every aspect of the proposal, as summarized in Section I.C above and as discussed in more detail, along with explanations of modifications made in light of the comments, throughout the release.

C. Small Entities Subject to the Rule

For purposes of a Commission rulemaking in connection with the RFA, a broker-dealer will be deemed a small entity if it: (i) 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,[1571] or, if not required to file such statements, had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter); and (ii) is not affiliated with any person (other than a natural person) that is not a small business or small organization.[1572]

1571 17 CFR 240.17a-5(d).

1572 *See* 17 CFR 240.0-10(c).

As discussed in Section IV above, the Commission estimates that as of December 31, 2018, approximately 2,766 retail broker-dealers will be subject to Regulation Best Interest and the amendments to Rules 17a-3 and 17a-4.[1573] Based on FOCUS Report data,[1574] the Commission estimated that as of December 31, 2018, approximately 756 of those retail broker-dealers might be deemed small entities for purposes of this analysis.[1575] 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.[1576] Of these 756 small entities, the Commission estimates that 623 are standalone broker-dealers and 133 are dually registered as investment advisers.[1577]

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The new requirements impose certain reporting and compliance requirements on certain broker-dealers, including those that are small entities. The new requirements are summarized in this FRFA (Section V.A. above). All of these requirements are also discussed in detail, in

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1573 As noted above, this estimate likely overstates the number that would be impacted by Regulation Best Interest. *See supra* Section III.C.1.a.

1574 *See supra* footnote 1385.

1575 *See supra* footnote 1387.

1576 Consistent with the PRA, unless otherwise notes, we use the terms "registered representative" and "dually registered representative of a broker-dealer" herein.

1577 These estimate are based on FOCUS Report Data, *see supra* footnote 1385

Section II above, and these requirements as well as the costs and burdens on broker-dealers, including those that are small entities, are discussed above in Sections III and IV (the Economic Analysis and PRA Analysis) and below.

1. Disclosure Obligation

The Disclosure Obligation under Regulation Best Interest requires a broker-dealer or its associated persons, prior to or at the time of recommending a securities transaction or strategy involving securities to a retail customer, to provide the retail customer, in writing, full and fair disclosure of: (1) all material facts relating to the scope and terms of the relationship with the retail customer, including: (a) 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, (b) the fees and costs that apply to the retail customer's transactions, holdings, and accounts, and (c) 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 (2) all material facts relating to conflicts of interest that are associated with the recommendation. The estimated costs and burdens incurred by small entities in relation to this Disclosure Obligation are discussed in detail below.[1578]

a. Obligation to Provide to the Retail Customer Full and Fair Disclosure, in Writing, of all Material Facts Relating to the Scope and Terms of the Relationship with the Retail Customer

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[1578] For a discussion of additional costs and burdens as well as monetized burdens, related to the Disclosure Obligation, *see supra* Section III.C.2.b.

The Commission assumes for purposes of this analysis that small entities would meet the obligation to disclose to the retail customer, in writing, the material facts related to the scope and terms of the relationship with the retail customer through a combination of delivery of the Relationship Summary,[1579] creating account disclosures to include standardized language related to the capacity in which they are acting and type and scope of services, and the development of fee schedules.

b. Estimated Costs and Burdens

In addition to the costs described below, additional costs associated with Regulation Best Interest are described above in Section III.C.[1580]

(1) Disclosure of Capacity, Type and Scope of Services

As explained above, standalone broker-dealers that are small entities will satisfy the obligation to disclose the capacity in which they acting through the delivery to the retail customer of the Relationship Summary, and accordingly, we estimate zero burden hours for standalone broker-dealers that are small entities to disclose the capacity in which they are acting.

We estimate that a dually registered firm that is a small entity will incur an initial internal burden of 10 hours for in-house counsel and in-house compliance to draft language regarding the capacity in which it is acting for inclusion in the standardized account disclosure that is delivered

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1579 *See* Exchange Act Rule 17a-14 and Relationship Summary Adopting Release, *supra* footnote 12.

1580 *See* Sections III.C.2.b, III.C.3.b, III.C.4, III.C.5, and III.C.6.

to the retail customer.[1581] In addition, we estimate that dual-registrants that are small entities will incur an estimated external cost of $4,970 for the assistance of outside counsel in the preparation and review of standardized language regarding capacity.[1582] For the estimated 133 dually registered broker-dealers that are small entities, we project an aggregate initial burden of 1,330 hours,[1583] and $661,010 in aggregate initial costs for drafting language regarding capacity.[1584]

Similarly, to comply with Regulation Best Interest, we believe that small entities will draft standardized language for inclusion in the account disclosure to provide the retail customer with more specific information regarding the type and scope of services that they provide. We estimate that a small entity will incur an internal initial burden of 10 hours for in-house counsel and in-house compliance to draft this standardized language.[1585] In addition, a small entity will incur an estimated external cost of $4,970 for the assistance of outside counsel in the preparation

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1581 *See supra* footnotes 1396-1397.

1582 *See supra* footnote 1398.

1583 *See supra* footnote 1396. This estimate is based on the following calculation: (133 dually registered retail firms that are small entities) x (10 hours) = 1,330 initial aggregate burden hours.) The professional skills associated with the estimated burden hours are specified in Section IV above.

1584 This estimate is based on the following calculation: (133 dually registered retail firms that are small entities) x ($4,970 in external cost per firm) = $661,010 in aggregate initial costs.

1585 *See supra* footnote 1403.

and review of this standardized language.[1586] For the estimated 756 small entities,[1587] we project an aggregate initial burden of 7,560 hours,[1588] and aggregate initial costs of $3.8 million for drafting language regarding type and scope of services.[1589]

We estimate that small entities will each incur approximately 0.02 burden hours[1590] for delivery of the account disclosure document.[1591] Based on FOCUS data, we believe that the 756 small entities have a total of 5,281 customer accounts, and that approximately all of those accounts belong to retail customers.[1592] We therefore estimate that small entities will have an aggregate initial burden of 106 hours, or approximately 0.14 hours[1593] per small entity for the

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1586 *See supra* footnote 1404.

1587 *See supra* footnote 1386 and accompanying text.

1588 *See supra* footnote 1406.

1589 *See supra* footnote 1407.

1590 *See supra* footnote 1412.

1591 *See supra* footnote 1413.

1592 This estimate may overstate the number of retail customer accounts at small entities and/or may 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.

1593 These estimates are based on the following calculations: (0.02 hours per customer account x (5,281 retail customer accounts) = 106 aggregate burden hours. Conversely, (106 hours) / (756 small entities) = approximately 0.14 burden hours per small entity for the first year after Regulation Best Interest is in effect.

first year after Regulation Best Interest is in effect for delivery of the account disclosure document.[1594]

We therefore estimate a total initial aggregate burden for small entities to develop and deliver to retail customers account disclosures relating to the capacity in which they are acting and type and scope of services of 7,666 burden hours.[1595]

In terms of ongoing costs, we estimate that each dually registered broker-dealer that is a small entity will incur approximately 5 burden hours annually for in-house compliance and business-line personnel to review changes in the dual-registrant's capacity, and another 2 burden hours annually for in-house counsel to amend the account disclosure to disclose material changes to the dual-registrant's capacity, for a total of 7 burden hours. The estimated ongoing aggregate burden to amend account disclosures of dual-registrants that are small entities to reflect changes in capacity is therefore 931 hours per year.[1596]

With respect to small entities, we estimate an internal burden of 2 hours for in-house compliance and business-line personnel to review and update changes in types or scope of

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1594 *See supra* footnote 1416.

1595 This estimate is based on the following calculation: (1,330 aggregate initial burden hours for dually registered broker-dealers that are small entities) + (6,230 aggregate initial burden hours for standalone broker-dealers that are small entities) + (106 aggregate initial burden hours for small entities to deliver the account disclosures) = 7,666 total aggregate initial burden hours.

1596 This estimate is based on the following calculation: (7 burden hours per dually registered firm per year) x 133 dually registered broker-dealers that are small entities) = 931 ongoing aggregate burden hours per year.

services,[1597] and another 2 burden hours annually for in-house counsel to amend the account disclosure to disclose material changes to type and scope of services—for a total of 4 burden hours per year. The estimated ongoing aggregate burden for standalone broker-dealers that are small entities to amend account disclosures to reflect changes in type and scope of services is therefore 2,492 hours per year.[1598]

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 small entities to incur a total annual aggregate burden of 21 hours, or 0.03 hours per small entity per year.[1599]

1597 As noted above, we estimate zero burden hours annually for standalone broker-dealers that are small entities relating to disclosure of capacity under the Disclosure Obligation. *See supra* Section IV.B.1.a.ii.

1598 This estimate is based on the following calculation: (4 burden hours per small entity per year) x (623 standalone broker-dealers that are small entities) = 2,492 ongoing aggregate burden hours per year.

1599 (20%) x (5,281 retail customer accounts) x (0.02 hours for delivery to each customer account) = 21 aggregate burden hours per year. Conversely, 21 aggregate burden hours / 756 small entities = 0.03 burden hours per small entity per year.

The total ongoing aggregate burden for small entities to review, amend, and deliver updated account disclosures to reflect changes in capacity, type and scope of services would be 3,444 burden hours per year.[1600]

The Commission acknowledges that the types of services and product offerings vary greatly by broker-dealer, and therefore the costs or burdens associated with updating the account disclosure might also vary.

(2) Disclosure of Fees and Costs

As stated above, while we anticipate that many small entities may already create fee schedules, we believe that small entities will initially spend 5 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 $2,485 for small entities.[1601] We therefore estimate the initial aggregate burden for small entities to be 3,780 burden hours,[1602] and the initial aggregate cost to be $1.88 million.[1603]

1600 This estimate is based on the following calculation: (931 ongoing aggregate burden hours for dually registered broker-dealers that are small entities) + (2,492 ongoing aggregate burden hours for standalone broker-dealers that are small entities) + (21 ongoing aggregate burden hours for delivery of amended account disclosures) = 3,444 total ongoing aggregate burden hours per year.

1601 *See supra* footnote 1427.

1602 *See supra* footnote 1429.

1603 *See supra* footnote 1430.

Similar to delivery of the account disclosure regarding capacity and type 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 hours to deliver to each retail customer.[1604] We therefore estimate that small entities will have an aggregate initial burden of 106 hours, or approximately 0.14 hours per small entity for the first year after Regulation Best Interest is in effect.[1605]

With respect to small entities, we estimate that reviewing and updating the fee schedule will require approximately 2 hours per year. Based on these estimates, we estimate the recurring, aggregate, annualized burden will be 1,512 hours for small entities.[1606] We do not anticipate that small entities will 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.

1604 *See supra* footnote 1412.

1605 This estimate is based on the following calculation: (5,281 retail customer accounts) x (0.02 hours for delivery to each customer account) = 106 aggregate burden hours. Conversely, (106 aggregate burden hours) / (756 small entities) = 0.14 burden hours per small entity for the first year after Regulation Best Interest is in effect.

1606 *See supra* footnote 1438.

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, and that small entities will require approximately 0.02 hours to deliver the amended fee schedule to each retail customer. We therefore estimate small entities would incur a total annual aggregate burden of 42 hours, or 0.06 hours per small entity.[1607]

The Commission acknowledges that the type of fee schedule may vary greatly by small entity and therefore that the costs or burdens associated with updating the standardized fee schedule might similarly vary.

(3) Disclosure of All Material Facts Relating to Conflicts of Interest Associated with the Recommendation

We believe that many or most small entities will develop a standardized conflict disclosure document and deliver it to their retail customers.[1608] For small entities, we estimate it will take in-house counsel, on average, 5 burden hours to create the standardized conflict disclosure document and outside counsel 5 hours to review and revise the document. We estimate that the initial aggregate burden for the development of a standardized disclosure document, based on an estimated 756 small entities, will be 3,780 burden hours.[1609] We

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1607 This estimate is based on the following calculation: (40% of 5,281 retail customer accounts) x (0.02 hours) = 42 aggregate burden hours. Conversely, (42 aggregate burden hours) / (756 small entities) = 0.06 burden hours per small entity per year.

1608 *See supra* footnote 1444.

1609 *See supra* footnote 1445.

additionally estimate an initial cost of $2,485 per small entity,[1610] and an aggregate initial cost of $1.88 million for all small broker-dealers.[1611]

We assume that small entities will 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 will require approximately 0.02 hours to deliver the standardized conflict disclosure document to each retail customer.[1612] We therefore estimate that small entities will incur an aggregate initial burden of 106 hours, or approximately 0.14 hours per small entity for delivery of the standardized conflict disclosure document the first year after Regulation Best Interest is in effect.[1613] Accordingly, the

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1610 *See supra* footnote 1446.

1611 *See supra* footnote 1447.

1612 *See supra* footnote 1412. For purposes of this analysis, we have assumed any initial disclosures made by the small entities related to material conflicts of interest will be delivered together.

1613 These estimates are based on the following calculations: (0.02 hours per customer account x 5,281 retail customer accounts) = 106 aggregate burden hours. Conversely, (106 hours) / (756 small entities) = 0.14 burden hours per small entity for the first year after Regulation Best Interest is in effect.

total aggregate initial burden for small entities is estimated at 3,886 hours,[1614] and the total aggregate initial cost is estimated at $1.88 million.[1615]

We believe that small entities will incur ongoing annual burdens and costs to update the disclosure document to include newly identified conflicts. We estimate that in-house counsel at a small entity will require approximately 1 hour per year to update the standardized conflict disclosure document, for an ongoing aggregate burden of approximately 756 hours per year.[1616] We do not anticipate that small entities will 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 will take place among 40% of a small entity's retail customer accounts annually, and that small entities will require approximately 0.02 hours to deliver the updated conflict disclosure document to each retail customer.[1617] We therefore estimate that small

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1614 This estimate is based on the following calculation: (3,780 aggregate initial burden hours for the development of a standardized conflict disclosure document) + (106 burden hours for delivery of the standardized conflict disclosure document) = 3,886 aggregate initial burden hours.

1615 *See supra* footnote 1430.

1616 *See supra* footnote 1454.

1617 *See supra* footnote 1456.

entities will incur an aggregate ongoing burden of 42 hours, or 0.06 burden hours per small entity per year.[1618]

2. Care Obligation

As discussed above in Section IV.B.2, we believe that any burdens or costs associated with the Care Obligation are accounted for in other obligations under Regulation Best Interest, including the Disclosure Obligation and the Record-making Obligation under Rule 17a-3(a)(35) and Recordkeeping Obligation under Rule 17a-4(e)(5). Other costs applicable to broker-dealers, including small entities, associated with the Care Obligation are discussed above in Section III.C.3.b.

3. Conflict of Interest Obligation

As described more fully above in Section IV.B.3, the Conflict of Interest Obligation would generally include the obligation to: (1) update written policies and procedures to comply with Regulation Best Interest and (2) establish mechanisms to proactively and systematically identify and manage conflicts of interest in its business on an ongoing or periodic basis.[1619]

[1618] This estimate is based on the following calculation: (40% of 5,281 retail customer accounts) x (0.02 hours) = 42 aggregate burden hours. Conversely, (42 aggregate burden hours per year) / (756 small entities) = 0.06 hours per small entity per year.

[1619] *See supra* Section IV.B.3. For a discussion of additional costs and burdens, as well as monetized burdens, related to the Conflict of Interest Obligation, *see supra* Section III.C.4.

a. Written Policies and Procedures

i. Initial Costs and Burdens

To initially comply with this obligation, we believe that small entities 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. We estimate that 40 hours of outside legal counsel services would be required, for a one-time initial cost of $19,880 per small entity,[1620] and an aggregate initial cost of $15.0 million for all small entities.[1621] We also expect that in-house compliance would require 10 hours to review and approve the updated policies and procedures, for an initial aggregate burden of 7,560 hours.[1622] Therefore, we estimate the total initial aggregate burden for small entities to be 128,160 hours[1623] and the total initial aggregate cost to be $25.0 million.[1624]

We believe that the related ongoing costs for small entities (relating to outside counsel reviewing and updating policies and procedures on a periodic basis) would be $2,485 annually for each small entity,[1625] and the projected aggregate, annual ongoing cost for small entities

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1620 *See supra* footnote 1478.

1621 *See supra* footnote 1479.

1622 *See supra* footnote 1480.

1623 *See supra* footnote 1481.

1624 *See supra* footnote 1482.

1625 *See supra* footnote 1487.

(relating to outside legal counsel) would be $1.88 million.[1626] In addition, we expect that small entities would require five hours of outside compliance services per year to update their policies and procedures, for an ongoing cost of $1,365 per year per small entity,[1627] and an aggregate ongoing cost of $1.03 million per year.[1628] The total aggregate, ongoing cost for small entities is therefore projected at $2.91 million per year.[1629]

In addition to the costs described above, we additionally believe small broker-dealers would incur an internal burden of approximately five 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 3,780 hours for in-house compliance manager review per year.[1630]

b. Identification and Management of Conflicts of Interest

To comply with Regulation Best Interest, we expect that small entities would modify existing technology through an outside programmer which would require, on average, an estimated 20 hours, for an estimated initial cost per small entity of $5,680.[1631] We additionally continue to project that coordination between the programmer and the small entity's compliance

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1626 *See supra* footnote 1488.

1627 *See supra* footnote 1489.

1628 *See supra* footnote 1490.

1629 *See supra* footnote 1491.

1630 *See supra* footnote 1492.

1631 *See supra* footnote 1498.

manager would involve five initial burden hours. The aggregate initial costs and burdens for small entities for the modification of existing technology to identify conflicts of interest would therefore be $4.29 million,[1632] and 3,780 burden hours.[1633]

As a result of the changes made to the rule text of the Conflict of Interest Obligation of Regulation Best Interest, we believe that small entities would incur burdens to determine how to manage the conflict of interest. We believe that small entities would require approximately 20 hours per small entity,[1634] for an aggregate of 15,120 initial burden hours for all small entities.[1635] The total initial aggregate burden for small entities for identification and management of conflicts of interest is therefore 18,900 initial burden hours.[1636]

To maintain compliance with the Conflict of Interest Obligation, we believe that for purposes of this analysis, small entities would, through the help of the business line and

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1632 This cost estimate is based on the following calculation: ($5,680 in outside programmer costs per broker-dealer) x (756 small entities) = $4.29 million in aggregate initial outside programmer costs.

1633 This burden estimate is based on the following calculation: (5 burden hours) x (756 small entities) = 3,780 aggregate initial burden hours.

1634 *See supra* footnotes 1502 and 1503.

1635 This burden estimate is based on the following calculation: (20 burden hours) x (756 small entities) = 15,120 aggregate initial burden hours.

1636 This burden estimate is based on the following calculation: (3,780 burden hours for modification of technology) + (15,120 burden hours for evaluation of managing conflicts) = 18,900 total aggregate initial burden hours.

compliance personnel, spend on average 10 hours[1637] to perform an annual conflicts review using the modified technology infrastructure.[1638] Therefore, the aggregate ongoing burden for an annual conflicts review, based on an estimated 756 small entities, would be approximately 7,560 burden hours per year.[1639] Because we assume that small entities would use in-house personnel to identify and evaluate new, potential conflicts, we continue to believe they would not incur additional ongoing costs.

c. Training

As discussed in the Proposing Release, we expect that small entities would develop training programs to comply with Regulation Best Interest, including the Conflict of Interest Obligation. However, we believe that any burdens and costs associated with a training program would fall under the new Compliance Obligation as it would be developed to comply with the rule as a whole, including each of the component obligations.

In total, to comply with the Conflict of Interest Obligation, the Commission estimates that the total initial burdens and costs for small entities to be 135,720 hours[1640] and $29.29

1637 *See supra* footnote 1508.

1638 *See supra* footnote 1509.

1639 This estimate is based on the following calculation: (10 hours of labor per small entity per year) x (756 small entities) = 7,560 aggregate burden hours per year.

1640 This estimate is based on the following calculation: (128,160 burden hours for written policies and procedures) + (7,560 burden hours for identification and management of conflicts of interest) = 135,720 hours.

million[1641] and the total ongoing burdens and costs for small entities to be 11,340 hours[1642] and $2.91 million.[1643]

4. Compliance Obligation

As discussed above, in response to comments that we should require policies and procedures to comply with the rule as a whole, we are adopting the Compliance Obligation.[1644] Because we did not include the Compliance Obligation in the Proposing Release, we did not include costs and burdens associated with the Compliance Obligation, but have provided a detailed explanation in Section IV.B.4 above, and a summary below.

To comply with the Compliance Obligation, we believe that small entities would primarily rely on outside counsel to update existing policies and procedures, and that 20 hours of outside legal counsel services would be required, for a one-time cost of $9,940 per small entity,[1645] and an aggregate initial cost of $7.5 million for all small entities.[1646] We also expect

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1641 This estimate is based on the following calculation: ($25 million initial aggregate costs relating to written policies and procedures) + ($4.29 million initial aggregate costs for modification of existing technology to identify conflicts of interest) = $29.29 million initial aggregate costs.

1642 This estimate is based on the following calculation: (3,780 burden hours for reviewing and approving the updated policies and procedures) + (7,560 burden hours for annual conflicts review) = 11,340 initial aggregate burden hours.

1643 *See supra* footnote 1629.

1644 Section II.C.4.

1645 *See supra* footnote 1524.

1646 *See supra* footnote 1525.

that in-house compliance personnel would require 6 hours to review and approve the updated policies and procedures, for an aggregate initial burden of 4,536 hours.[1647]

In terms of ongoing costs, we assume for purposes of this analysis that small entities would mostly rely on outside legal counsel and compliance consultants for review and update of their policies and procedures, with final review and approval from an in-house compliance manager. We estimate that outside counsel would require approximately five hours per year to update policies and procedures, for an annual cost of $2,485 for each small entity.[1648] The projected aggregate, annual ongoing cost for outside legal counsel to update policies and procedures for small entities would be $1.88 million per year.[1649] In addition, we expect that a small entity would require five hours of outside compliance services per year to update its policies and procedures, for an ongoing cost of $1,365 per year,[1650] and an aggregate ongoing cost of $1.03 million per year.[1651] The total aggregate, ongoing cost for small entities is therefore projected at $2.91 million per year.[1652]

1647 *See supra* footnote 1526.

1648 *See supra* footnote 1530.

1649 *See supra* footnote 1531.

1650 *See supra* footnote 1532.

1651 *See supra* footnote 1533.

1652 *See supra* footnote 1534.

a. Training

Pursuant to the obligation to "maintain and enforce" written policies and procedures, we additionally believe small entities will develop training programs that promote compliance with Regulation Best Interest.

We estimate that a small entity would retain an outside systems analyst, outside programmer, and an outside programmer analyst to create a training module, at 20 hours, 40 hours, and 20 hours, respectively. The total cost to develop the training module would be approximately $20,920 per small entity,[1653] for an aggregate initial cost to small entities of $17.18 million.[1654]

Additionally, we expect that the training module would require the approval of the Chief Compliance Officer, as well as in-house counsel, each of whom would require approximately 2 hours to review and approve the training module. The initial aggregate burden for small entities is therefore estimated at 3,024 initial burden hours.[1655]

In addition, small entities would incur an initial cost for registered representatives to undergo training through the training module. We estimate the training time at one hour per

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1653 *See supra* footnote 1535.

1654 This estimate is based on the following calculation: (756 small entities) x ($20,920 initial costs per broker-dealer) = $15.81 million in aggregate initial costs for technology services.

1655 This estimate is based on the following calculation: (756 small entities) x (4 initial burden hours per small entity) = 3,024 initial burden hours.

associated person, for an aggregate initial burden of 5,094 burden hours, or an initial burden of 6.7 hours per small entity.[1656] The total aggregate burden to approve the training module and implement the training program would be 8,118 initial burden hours.[1657]

For purposes of this analysis, 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 5,094 burden hours per year, or 6.7 burden hours per small entity per year.[1658]

In total, for small entities to comply with the Compliance Obligation, the Commission estimates the total initial burdens and costs to be 12,654 hours[1659] and $23.31 million,[1660] and the total ongoing burdens and costs to be 5,094 hours[1661] and $2.91 million.[1662]

1656 This estimate is based on the following calculation: (1 burden hour) x (5094 registered representatives at small entities) = 5,094 aggregate initial burden hours. Conversely, (5,094 aggregate burden hours) / (756 small entities) = 6.7 initial burden hours per broker-dealer.

1657 This estimate is based on the following calculation: (5,094 burden hours for training of registered representatives) + (3,024 burden hours to approve training program) = 8,118 total aggregate initial burden hours.

1658 *See supra* footnote 1656.

1659 This estimate is based on the following calculation: (4,536 initial burden hours for policies and procedures) + (8,118 initial burden hours training) = 12,654 initial burden hours to comply with Compliance Obligation.

1660 This estimate is based on the following calculation: ($7.5 million initial costs for policies and procedures) + ($15.81 million initial costs for training) = $23.31 million initial total costs to comply with Compliance Obligation.

5. Record-Making and Recordkeeping Obligations

The record-making and recordkeeping obligations will impose record-making and recordkeeping requirements on broker-dealers with respect to certain information collected from, or provided to, retail customers.

a. Record-Making Obligation

As discussed above, we continue to believe that small entities will satisfy the record-making requirements of the amendment to Rule 17a-3(a)(35) by amending an existing account disclosure document to include certain information.[1663] We believe that the inclusion of this information in an account disclosure document will require, on average, approximately 1 hour per year for outside counsel at small entities, at an updated average rate of $497/hour, for an annual cost of $497 for each small entity to update an account disclosure document. The projected initial, aggregate cost for small entities is therefore estimated to be $375,732.[1664] Finally, we estimate it will 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

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1661 This estimate is based on the following calculation: (0 ongoing burden hours for policies and procedures) + (5,094 ongoing burden hours for training) = 5,094 ongoing burden hours to comply with Compliance Obligation.

1662 This estimate is based on the following calculation: ($2.91 million ongoing costs for policies and procedures) + ($0 ongoing costs for training) = $2.91 million ongoing total costs to comply with Compliance Obligation.

1663 *See supra* Section IV.B.5.a.i.

1664 *See supra* footnote 1549.

account disclosure document, for an approximate total aggregate initial burden of 211 hours, or approximately 0.28 hours per small entity for the first year after the rule is in effect.[1665]

Because we have already included the costs and burdens associated with the creation of a record to memorialize an oral disclosure, and the delivery of the amended account disclosure document in Section V.D.1., we need not include them in this section of the analysis.

We do not believe that the identity of the registered representative responsible for the retail customer's account will change. Accordingly, we continue believe that there are no ongoing costs and burdens associated with this record-making requirement of the amendment to Rule 17a-3(a)(35). With respect to memorializing oral disclosures, we estimate that this would take place among 52% of a small entity's retail customers (and thus 52% of a registered representative's retail customer accounts) annually.[1666] We therefore estimate that small entities will incur a total annual aggregate ongoing burden of 55 hours or 0.07 hours per small entity per year.[1667]

1665 These estimates are based on the following calculations: (0.04 hours per customer account) x (5,281 retail customer accounts at small entities) = 211 aggregate initial burden hours. Conversely, (211 burden hours) / (756 small entities) = 0.28 initial burden hours per broker-dealer.

1666 *See supra* footnote 1555.

1667 (52%) x (5,281 retail customer accounts at small entities) x (0.02 hours for recording each oral disclosure relating to a retail customer's account) = 55 aggregate burden hours per year. Conversely, 55 aggregate burden hours / 756 small entities = 0.07 ongoing burden hours per small entity per year.

b. Recordkeeping Obligation

For purposes of this analysis, we assume the following records would likely be retained pursuant to amended Rule 17a-3(a)(35): (1) existing account disclosure documents; (2) comprehensive fee schedules; (3) disclosures identifying material conflicts; and (4) memorialized oral disclosures under the circumstances outlined in Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*.

Based on our belief that small entities will rely on existing infrastructures to satisfy the recordkeeping obligations of Regulation Best Interest and the amendment to Rule 17-a(4)(e)(5), we believe the burden for small entities to add new documents or modify existing documents to the small entity's existing retention system will be approximately 704 burden hours for small entities, assuming a small entity will need to upload or file each of the four account documents discussed above for each retail customer account.[1668] We do not believe there will be additional internal or external costs relating to the uploading or filing of the documents. In addition, because we have already included the costs and burdens associated with the delivery of the amended account opening agreement and other documents in Section V.D.1 above, we do not include them in this section of the analysis.

[1668] This estimate is based on the following calculation: (4 documents per customer account) x (5,281 retail customer accounts at small entities) x (2 minutes per document) / 60 minutes = 704 aggregate burden hours.

We estimate that the approximate ongoing burden associated with the recordkeeping requirement of the amendment to Rule 17a-4(e)(5) is 231 burden hours per year.[1669] 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.

E. Agency Action to Minimize Effect on Small Entities

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. As described in the Proposing Release we considered the following alternatives for small entities in relation to the new requirements: (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small

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[1669] This estimate is based on the percentage of account records we expect would be updated each year as described in Section IV.B.1, *supra,* and the following calculation: ((40% of fee schedules x 5,281 retail customer accounts at small entities) x (2 minutes per document) + (40% of conflict disclosure forms x 5,281 retail customer accounts at small entities) x (2 minutes per document) + (20% of account opening documents x 5,281 retail customer accounts at small entities) x (2 minutes per document)) = 10,560 minutes / 60 minutes = 176 aggregate ongoing burden hours. In addition, with respect to ongoing memorialization of the updated oral disclosures, we estimate that this will take place among 52% of a small entity's retail customer accounts annually. We therefore estimate that small entities will incur an aggregate ongoing burden of 55 hours, or 0.07 burden hours per broker-dealer (calculated as follows: (52% of updated oral disclosures x 5,281 retail customer accounts at small entities) x (1.2 minutes per document) = 3,295 minutes / 60 minutes = 55 aggregate ongoing burden hours (or 55 aggregate burden hours / 756 small entities = 0.07 burden hours per small entity)). 176 hours + 55 hours = 231 total aggregate ongoing burden hours.

entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the new requirements, or any part thereof, for such small entities.

Regarding the first alternative, the Commission does not believe that we could effectively achieve our stated objectives by establishing different requirements applicable to broker-dealers of different sizes. We considered adopting tiered compliance dates so that smaller broker-dealers would have had more time to comply. However, as discussed in Section II.E above, we believe the operational capability needed to develop processes to comply with Regulation Best Interest is sufficiently established by firms of all sizes and resources. The Commission has determined, in light of the importance of the protections afforded by Regulation Best Interest to retail customers, that a Compliance Date of one year after the Effective Date is an appropriate timeframe for firms to conduct the requisite operational changes to their systems to establish internal processes to comply with Regulation Best Interest. Further, as discussed above in Section III, each of the component obligations in Regulation Best Interest shares features with existing market best practices, as shaped by FINRA's guidance on relevant rules or as described in its Report on Conflicts of Interest.[1670] To the extent that broker-dealer (and small entity) practices are already aligned with the requirements of Regulation Best Interest, the anticipated

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[1670] *See supra* Section III.C.1.b.

magnitude of the costs associated with a given component of the rule will be correspondingly reduced.[1671]

As discussed above, we believe that Regulation Best Interest will result in important investor protection benefits, and these benefits apply to retail customers of smaller entities as well as retail customers of large broker-dealers. For example, a primary objective of this rulemaking 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 establishing differing compliance or reporting requirements or timetables for broker-dealers that are small entities under Regulation Best Interest and the amendments to Rules 17a-3 and 17a-4(e)(5).

Moreover, we continue to believe that 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 with other advice relationships (e.g., a relationship with an investment adviser). 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

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[1671] *See supra* text following footnote 1159.

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 as described in the Proposing Release, we still do not believe that additional clarification, consolidation, or simplification of compliance and reporting requirements would be appropriate for small entities. We note, however, in crafting Regulation Best Interest, we generally aimed to provide broker-dealers flexibility in determining how to satisfy the component obligations. We continue to believe that this flexibility reflects a general performance-based approach, rather than design-based approach.

As discussed in the Economic Analysis in Section III.E above, the Commission also considered a number of alternatives as they affect all firms, including small entities. Specifically, the Commission considered three different options for imposing a fiduciary standard on broker-dealers: (1) applying the fiduciary standard under the Advisers Act to broker-dealers; (2) adopting a "new" uniform fiduciary standard of conduct applicable to both broker-dealers and investment advisers, such as that recommended by the staff in the 913 Study, and, or (3) adopting similar standards to what the DOL had provided under its fiduciary rule to broker-dealers and investment advisers. The Commission further considered requiring broker-dealers to use a specific form for disclosure, similar to, for example, Form ADV Part II in lieu of the flexible approach of the Disclosure Obligation, or in the alternative, developing a disclosure-only standard, which would require that broker-dealers satisfy only the Disclosure Obligation of the final rule.

We acknowledge certain commenters urged the Commission to take additional or different regulatory actions than the approach we have adopted, including the alternatives discussed above. We do not believe that any rulemaking governing retail investor-advice relationships can solve for every issue presented. After careful consideration of the comments and additional information we have received, we believe that Regulation Best Interest, as modified, appropriately balances the concerns of the various commenters in a way that will best achieve the Commission's important goals of enhancing retail investor protection and decision making, while preserving, to the extent possible, retail investor access (in terms of choice and cost) to differing types of investment services and products.

VI. STATUTORY AUTHORITY AND TEXT OF THE RULE

Pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act Section 913(f), Pub. L. 111-203, 124 Stat. 1376, 1827 (2010), and Exchange Act sections 3, 10, 15, 15(c)(6), 15(*l*), 17, 23 and 36 thereof, 15 U.S.C. 78c, 78j, 78o, 78o(c)(6), 78o(*l*), 78q, 78w and 78mm, the Commission is adopting § 240.15*l*-1 and adopting amendments to § 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

17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

Text of the Rule

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 is revised by adding sectional authorities for section 240.15*l*-1 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, 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; and 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 240.15*l*-1 is also issued under Pub. L. 111-203, sec. 913, 124 Stat. 1376, 1827 (2010).

* * * * *

2. Add § 240.15*l*-1 to read as follows:

§ 240.15*l*-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 (including account recommendations) 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 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:

(i) 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;

(ii) The material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and

(iii) 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.

(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, 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;

(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.

(iii) Conflict of Interest Obligation. 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 subparagraph (a)(2)(i), 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) (i) 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

(ii) 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.

(iv) Compliance Obligation. In addition to the policies and procedures required by paragraph (iii), the broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

(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 for purposes of this section:

(1) *Retail Customer* means 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.

(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) *Conflict of Interest* means an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer —consciously or unconsciously—to make a recommendation that is not disinterested.

3. Amend § 240.17a-3 by adding new paragraphs (a)(24) – (a)(35) to read as follows:

§ 240.17a-3 Records to be made by certain exchange members, brokers and dealers.

(a)***

(24) [Reserved.]

(25) [Reserved.]

(26) [Reserved.]

(27) [Reserved.]

(28) [Reserved.]

(29) [Reserved.]

(30) [Reserved.]

(31) [Reserved.]

(32) [Reserved.]

(33) [Reserved.]

(34) [Reserved.]

(35) 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 § 240.15*l*-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)(35), the neglect, refusal, or inability of the retail customer to provide or update any information described in paragraph (a)(35)(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)(35), 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: June 5, 2019

Vanessa A. Countryman
Acting Secretary