NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

# Report and Findings of NASAA's Broker-Dealer Section Committee

## National Examination Initiative Phase II (B)

September 2023

# Introduction

NASAA's Broker-Dealer Section Committee (the "Committee") has concluded Phase II (B) of its Coordinated National Regulation Best Interest Examination Initiative ("Phase II (B) Exam"). The Phase II (B) Exam was the sequel to two prior Regulation Best Interest ("Reg BI") exam initiatives conducted by the NASAA membership. The Phase I exam initiative took a broad snapshot of the entire investment industry in 2018, prior to the SEC's adoption of Reg BI, to set up industry baselines that compared the policies, procedures, and practices of FINRA firms operating under the suitability standard with the policies, procedures, and practices of investment advisers operating as fiduciaries. The Phase II (A) exam initiative took a more targeted and in-depth look at FINRA firms in the first year following the SEC's compliance deadline for Reg BI.

Both the Phase I and Phase II (A) exam initiatives focused on four types of complex, costly, risky products – leveraged and inverse exchange-traded funds, non-traded REITs, variable annuities, and private placements ("CCRs"). Both exam initiatives were conducted through the submission of electronic questionnaires that were answered by firm personnel, using a common set of questions focused on the core component obligations of Reg BI. Both exam initiatives collected quantitative data to allow apple-to-apple comparisons between FINRA firms and investment advisers in Phase I and to document changes in FINRA firm policies, procedures, and practices in the early transition to Reg BI in Phase II (A). NASAA reported state findings as well as aggregated firm responses to exam questions in September of 2020 (Phase I) and November of 2021 (Phase II).

The Phase II (B) exam initiative, by contrast, was conducted through on-site or remote examinations conducted by state examiners evaluating FINRA firm compliance in years two and three of Reg BI. State examiners used a common set of examination modules that focused on the same four product types reviewed in the first two phases, as well as a comprehensive module that analyzed firm compliance with Reg BI's overarching Compliance Obligation. Unlike the earlier exams, the Phase II (B) exam initiative focused on qualitative findings to identify areas where FINRA firms were meeting or exceeding state expectations regarding Reg BI compliance (best practices) as well as identifying areas where FINRA firm compliance appeared weak (opportunities for improvement). Pursuant to each state's laws, records obtained during the Phase II (B) exams are confidential. As such, exam information reported to the Committee did not include the identity of the firms examined.

While states were provided examination modules to use as a guide, each participating state used its own discretion in selecting firms to examine. Accordingly, the firms examined during Phase II (B) varied in size, business model, and location. Similarly, the scope of each examination was also unique to each state, with state examiners focusing their efforts on the products of most interest or relevance to their jurisdictions. In total, this Phase II (B) Report used information from over 200 on-site or remote state examinations conducted by 25 states.

## Key Findings

The purpose of Phase II (B) was to supplement the industry-wide findings in Phase II (A) with a transaction-level review of products recommended by FINRA firms. As before, the states focused their attention on four complex, costly, and risky product types: the aforementioned CCRs (leveraged and inverse ETFs, non-traded REITs, private placements, and variable annuities).

To recap, in Phase II (A), the states observed that:

- Few firms made significant changes to their product shelves or their policies, procedures, and compliance systems when they transitioned from the suitability rule to Reg BI;
- More firms participated in CCR products under Reg BI than they did under the suitability rule, but the rate of recommendation decreased;
- Firms recommending CCR products after Reg BI relied on financial incentives to sell products more than firms that did not recommend CCR products;
- Few firms considered or offered lower-cost or lower-risk alternatives when recommending CCR products to their customers; and
- Many firms continued to rely on the product prospectuses and generalized boilerplate disclosures on their websites rather than direct point-of-sale disclosures to communicate the risks, rewards, and costs associated with their recommendations after Reg BI.

In Phase II (B), the states observed that:

- Firms have been updating their investor profile forms and enhancing their policies and procedures to focus more directly on Reg BI obligations, though more specific instruction is needed with respect to considerations of reasonably available alternatives and conflict mitigation;
- Firms recommending CCR products are imposing product-specific restrictions based on age, net income/worth, and risk profiles and are using exception reports to monitor compliance with those restrictions;
- Firms are using helpful cost-comparison tools to better consider reasonably available alternatives, but are still ignoring common lower-cost and lower-risk products when recommending CCRs;
- Firms are still relying on financial incentives to sell CCR products and there is little uniformity in implementing effective firm mitigation strategies; and

- Firms have not enhanced point-of-sale disclosure, but they have devoted significant time, energy, and effort to compliance with Reg BI's Disclosure Obligation by crafting the Form CRS and detailed Supplemental Reg BI disclosures, along with disclosure information available via link to the firm's website.

While the Phase II (B) exams reveal helpful and steady implementation progress by the firms examined, firms are still relying heavily on suitability policies and strategies that pre-dated Reg BI. Efforts to address the standard of care concepts established by Reg BI remain perfunctory. In short, more work needs to be done to truly elevate the standard of care for retail customers.

The Phase II (B) Report shares state examiner views of Reg BI best practices and provides specific examples where firms are falling short of Reg BI principles, as discussed by the SEC in the 2019 Adopting Release ("SEC Adopting Release") and supplemental guidance that the SEC has published in the first three years of Reg BI implementation.[1] The Report addresses firm policies, procedures, and practices involving the four CCR types and provides commentary regarding each of Reg BI's four component obligations.

## Observations Regarding Complex Products

While states used a single tool – a common exam questionnaire issued to firms for their submission – to complete the Phase I and Phase II (A) exams, states had a variety of modules they could use for the Phase II (B) exams. Many states utilized the generic Reg BI module that was modeled after the questionnaire used in the first two phases. With respect to the four CCR product modules, most states focused their efforts on two products: non-traded REITs and private placements. Fewer states completed exams reviewing variable annuities and leveraged and inverse ETFs sales. Committee observations regarding each type is set below.

### *Leveraged and Inverse ETFs*

Although the exam sample was small, most of the firms examined in Phase II (B) either prohibited or severely restricted recommendations of non-traditional ETFs. Examples include firms permitting the use of ETFs only in advisory accounts of clients of the investment adviser, in personal and family accounts of the associated person, or permitting non-solicited trades but prohibiting solicited trades.

Where permitted, firms tended to limit recommendations to customers with a speculative risk tolerance or specific investment objective, such as hedging or day trading. Almost all firms examined used surveillance reports to monitor for transactions outside of firm requirements. Notably, the SEC Adopting Release specifically addresses

[1] 17 C.F.R. § 240.15*l*-1; Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 34-86031, (June 5, 2019), 84 Fed. Reg. 33,318, 33,320-21, 2019 WL 3043879 (July 12, 2019) ("Reg BI Adopting Release").

recommendations of leveraged and inverse ETFs, noting that they may not be in the best interest of a retail customer absent an identified, short-term trading objective.[2]

Leveraged and inverse ETFs are not generally regarded as high-cost products because selling expenses are typically low, so states did not ask firms about lower-cost alternatives. As noted above, leveraged and inverse ETFs are speculative, high-risk products, however, so states did ask firms whether they considered or offered the following lower-risk products when recommending nontraditional ETFs: traditional ETFs, mutual funds, individual equities, and options or other derivatives. Although few firms considered or offered those alternatives, the firm's compliance personnel offered logical, credible explanations why: namely, the lower-risk alternatives would not achieve the customer's stated investment objective, which was high-risk by design.

***Non-Traded REITs***

There was a healthy sample of Phase II (B) exams focused on recommendations of non-traded REITs. Almost all firms examined during Phase II (B) included the traditional suitability factors on their customers' investment profile forms. For riskier illiquid products like non-traded REITs, however, firms captured additional data or utilized other alternative investment-specific forms to document prior investment experience and other investment holdings.

The Phase II (B) exams reviewed whether firms had any formal product-specific requirements or prohibitions in recommending these products. Some of the firms examined limited non-traded REIT sales to accredited investors and nearly all had concentration limits related to a customer's net worth. Generally speaking, firms limited their retail customers to investing no more than 10% of their liquid net worth in these products or had prescriptive limits in the 10-20% ranges for alternative investment products as an asset class, which include non-traded REITs. Although concentration limits are routinely imposed through the product prospectus as a condition of registration in many states, firms had self-imposed (albeit higher) restrictions that applied across the board, reaching sales in states without prospectus guidelines.

In addition to concentration limits, nearly all examined firms formally restricted non-traded REIT sales based on one or more of the following factors: a customer's age (restrictions typically starting around age 60), stated risk profile (moderate to aggressive), need for liquidity (limited), and time horizon (long-term). Firms were more likely to impose limitations than to prohibit recommendations outright. An example of this limiting approach would be a firm reducing the overall percentage of a customer's net worth that may be allocated to illiquid investments for a customer over the age of 70, but not prohibiting recommendations to a customer based solely on age.

[2] "Further, [inverse and leveraged exchange-traded products] may not be in the best interest of a retail customer absent an identified, short-term, customer-specific trading objective . . ." (Reg BI Adopting Release, 84 Fed. Reg. at 33,376).

While, overall, most of the firms examined used some form of the aforementioned policies and practices to better match non-traded REITs with their customers, certain firms did not. States encountered multiple firms that had no formal requirements for these products.

Firms without any requirements should review the SEC Adopting Release, FINRA's Reg BI guidance, and the SEC's complaint in its first Reg BI case. The SEC Adopting Release suggests firms mitigate the risk of complex, high-risk products by "limiting the types of retail customer to whom a product, transaction or strategy may be recommended."[3] FINRA echoed this guidance in its 2022 Report on its Examination and Risk Monitoring Program[4] by recommending that firms mitigate the potential for recommendations that are not in a retail customer's best interest by "[l]imiting high-risk or complex investments for retail customers." FINRA specifically suggested firms consider "limiting high-risk or complex product, transaction or strategy recommendations to specific customer types."[5]

In the *Western International* complaint, the SEC described Reg BI violations where the firm "did not set any criteria or thresholds for its customers" and "did not restrict the sale … to customers with certain risk profiles or investment objectives." *SEC v. Western Intl. Secs., Inc.*, Case No. 2:22-cv-04119, at ¶146 (C.D. Cal. 2022).[6] The SEC also noted the firm's failure to guide its brokers on what constituted "substantial financial resources" and for not setting any limits on who could invest in the speculative bond at issue.

As non-traded REITs are both high-cost and high-risk, states asked firms whether they considered or offered any of the following lower-cost and lower-risk products before recommending non-traded REITs: individual equity of a company in the real estate sector, a real estate focused mutual fund, a real estate focused ETF, or a traded REIT. While specific investment recommendations have pros and cons outside the scope of this Report, the above-listed products will often be viable alternatives to non-traded REITs. All are lower-cost options than a non-traded REIT and, at a minimum, do not carry the same liquidity risk. Certain specific products within these product types also pay a similar dividend or yield to a non-traded REIT.

Few firms considered or offered those lower-cost and lower-risk alternatives. Unlike the more compelling explanations that firms offered for recommending non-traditional ETFs over lower-risk options, firms tended to offer vague and generic explanations why non-traded REITs were recommended in lieu of lower-cost and lower-risk alternatives. Moreover, a review of customer profile forms indicated customers did not always specify aggressive risk tolerances (Many specified a moderate appetite for risk; some even specified conservative.) and did not always specify speculation as an investment objective. Firms should review the SEC's charges in *Western International* to ensure they are properly matching their customers with non-traded REITs.

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[3] Reg BI Adopting Release, 84 Fed. Reg. at 33,392.

[4] FINRA, 2022 Report on FINRA's Examination and Risk Monitoring Program, (February 2022), https://www.finra.org/sites/default/files/2022-02/2022-report-finras-examination-risk-monitoring-program.pdf.

[5] Id.

[6] While *Western International* has not yet been finally li�gated, state regulators share the interpreta�on of Reg BI evident in the complaint.

### *Private Placements*

States also conducted a fair number of Phase II (B) exams focused on recommendations of private placements. Like non-traded REITs, private placements are illiquid, high-risk products for which firms have special policies and procedures. Firms generally capture more information from customers and more carefully assess customers' risk profiles before recommending these products.

As with non-traded REITs, nearly all the examined firms had net worth/income standards and concentration limits for private placements. All firms appeared to comply with federal laws that restrict private placement sales to accredited investors. Concentration limits were generally the same as those applied to non-traded REITs, presumably because the products are both illiquid and share a speculative risk profile.

For private placements, firms generally imposed the same kinds of restrictions regarding customers' age, stated risk profile, need for liquidity, and time horizon that were observed with non-traded REIT recommendations. Again, firms were more likely to limit recommendations based on these factors than categorically prohibit recommendations outright. These limitations make a lot of sense for the firms because private placements are a primary source of customer complaints and regulatory actions. From the state perspective, private placements have appeared in numerous NASAA Enforcement Reports over the years and have been identified repeatedly as products producing a high number of complaints and investigations.

As with non-traded REITs, there were a handful of firms that did not have any formal requirements for investing in private placements outside of limiting sales to accredited investors. Furthermore, multiple firms did not require agents to consider any lower-cost and lower-risk alternatives to private placements when making such a recommendation. The states reemphasize the recommendation that firms review the SEC's *Western International* complaint, specifically for more information on the application of Reg BI to illiquid alternative investments, and also more generally, along with the SEC Adopting Release and FINRA's Reg BI guidance, to ensure they are properly matching their customers with these illiquid, high-risk products.

### *Variable Annuities*

Variable annuities are complex and costly, routinely paying commissions of 6% or more. They require long-term holding to fully maximize benefits like favorable tax deferral and certain guarantees. Generally, firms did have restrictions in place, such as product concentration as a percentage of net worth, and certain firms used variable annuity specific forms to document these considerations and provide specific disclosures. However, multiple firms had no restrictions tied to key features of a variable annuity, like limiting sales to customers with a documented need for a death benefit and/or lifetime income payments. The SEC Adopting Release specifically addresses the importance of these features in making a best-interest determination.[7]

[7] Reg BI Adopting Release, 84 Fed. Reg. at 33,377.

Firms were generally found to utilize some exception reporting, but some firms failed to investigate the activity that generated an exception report. While firm supervisory procedures and compliance manuals typically included provisions to address variable annuity recommendations and related sales practice concerns, certain firms failed to include or implement procedures to identify perhaps the biggest sales practice risk of variable annuities: a customer incurring substantial surrender charges as variable annuities are repeatedly replaced.

The Phase II (B) exams also found that certain firms required agents to present customers with lower-cost, lower-risk products when recommending a variable annuity. However, these agents were not required to document these options. Other firms simply did not specifically require agents to consider lower-cost, or lower-risk products.

## Observations Regarding Reg BI's Component Obligations

As a refresher, the primary purpose of Reg BI was to elevate the broker-dealer standard of care from the suitability standard set forth in FINRA Rule 2111 to a new best interest standard of care that is no less rigorous than the fiduciary duty standard of care that is applied to investment advisers. The SEC articulates that standard as follows:

> ***Best Interest Obligation.*** *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.*[8]

NASAA used exam results from the Phase I and Phase II (A) exams to measure the progress that FINRA firms made in complying with Reg BI's directive to "act in the best interest of the retail customer" without placing their financial interests ahead of the interests of the retail customer. In Phase II (B), the Committee has analyzed firm policies, procedures, practices, and transactional data to see how firms are approaching their obligations of due diligence and care, disclosure, and conflict management obligations as Reg BI continues to evolve.

[8] 17 C.F.R. § 240.15*l*-1(a)(1).

### *Care Obligation*

The Care Obligation requires a broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation, to exercise reasonable diligence, care, and skill to understand the potential risks, rewards, and costs associated with the recommendation, and to have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers. This obligation further requires a reasonable basis to believe that the recommendation (or a series of recommendations) 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.[9]

The SEC applied the Care Obligation in the aforementioned *Western International* complaint.[10] Citing to the SEC Adopting Release, the SEC alleged that certain firm and agent practices do not comply with the Care and Compliance Obligations of Reg BI. These practices include failing to reasonably understand the investment, not setting any criteria for customers to invest in the product, and not restricting its sales to customers with certain risk profiles or investment objectives. Other allegedly violative conduct included agents recommending the high-risk product to customers who, based on their documented customer profile information, were not willing to accept the high-risk and illiquidity of the product and whose investment objectives were not speculative. Customers referenced in the complaint had both conservative and moderate risk tolerances. Finally, the SEC alleged that vague and generic rationales listed on alternative investment forms regarding why an investment is in the customer's best interest do not support the reasonable diligence, care, and skill necessary to believe the investment is in the customer's best interest.

In short, and as noted in the SEC Adopting Release, the Care Obligation requires firms to exercise due care in matching the right customer to the right product.[11]

Firm policies and practices observed in the Phase II (B) exams that fell short of that mark in the Committee's view include the following:

- Checkbox-style attestations with a naked claim that "other investment options were discussed with the client" or that the associated person considered unidentified "reasonably available alternatives;"

[9] 17 C.F.R. § 240.15*l*-1(a)(2)(ii).
[10] *SEC v. Western Intl. Secs., Inc.*, Case No. 2:22-cv-04119 (C.D. Cal. 2022).

[11] "[The SEC] emphasize[s] 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." (Reg BI Adopting Release, 84 Fed. Reg. at 33,382).

- Policies that require consideration of lower-cost, lower-risk alternatives without documentation or explanation of which, if any, alternatives were actually considered in a recommendation [only a few firms identified a list of specific product types that should be considered (e.g., a mutual fund) as alternatives];
- Failure to educate or otherwise provide guidance to associated persons on the firm's process for consideration of reasonably available alternatives (This is a presumptive breach of the Compliance Obligation.);[12]
- Failure to include customers' education level on investor profile forms as relevant to the customers' financial sophistication and ability to understand complex terms (This is a weakness for firms selling complex products, especially if the firm relies on lengthy product prospectuses to disclose most or all material facts related to the recommendation.).[13]

States noted many anomalies in firm documentation practices when it comes to the investment options considered by associated persons. Some firms provided associated persons with a list of products to be checked if considered while other firms allowed a narrative response. Certain firms were not effectively supervising these responses. State examiners saw the following:

- Narratives that did not mention any reasonably available alternatives at all;
- Identical narrative explanations on multiple (including a majority) of customer forms (copy/paste across forms);
- The only products listed as reasonably available alternatives carried significantly different risks than the recommended products (e.g. recommending a private placement and listing a CD as the other product considered, justifying the recommendation by stating the private placement provided a higher return); and
- The only products listed as reasonably available alternatives were the same product type (or in same asset class) that was recommended, offering no benefit in the form of reduced cost or risk (e.g. considering only non-traded REITs when recommending a non-traded REIT; only considering private placements).

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[12] *See* Reg BI Adopting Release, 84 Fed. Reg. at 33,393; SEC, Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers – Care Obligations (April 20, 2023), https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers; n.49 [*See* Reg BI Adopting Release, *supra* note 3, at 33,381 (noting that, under Reg BI's Compliance Obligation, a broker-dealer should have a reasonable process for establishing and understanding the scope of "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) … Similarly, Reg BI's Compliance Obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI.].

[13] Reg BI Adopting Release, 84 Fed. Reg. at 33,416-17, 33,432.

The Committee believes it is helpful for firms to provide associated persons with specific product alternatives (through questionnaire, list, or software) that can achieve the customer's investment objective at either a lower cost or at reduced risk in comparison to the product being recommended. Ideally, firms would present their associated persons with options that do both.

Phase II (B) exams also identified alternative investment transactions in which the customer's net worth, liquid net worth, or investable assets listed on the initial account opening documents were increased shortly before or at the time of the recommendation of the alternative investment so that the amount invested fell in line with investment concentration requirements. That is not new and was a problem under the suitability rule as well.

Examiners also saw variances in firm's recording of know your customer (KYC) data. One example would be where the firm approved recommendations without noticing inconsistent customer profile information (i.e. risk tolerance and investment objective changed across various firm-required forms). Another example would be where the firm created a special Reg BI form that asked customers to rank their appetite for risk on a scale of 1-10. The firm approved illiquid alternative investment recommendations at level 3 (described as "cautious risk taker"), even though that firm had a separate policy that limited illiquid investments sales to customers with an aggressive risk tolerance.

Pursuant to the SEC Adopting Release, when the match between the retail customer and the recommendation appears less reasonable on its face, the broker-dealer will need 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.[14] Firms cannot do that without reasonably designed policies and procedures to establish compliance with the Care Obligation, as required by the Compliance Obligation.[15]

Suitability forms and questionnaires have been used in alternative investment recommendations for quite some time to document investor risk profiles and confirm compliance with allocation limits, but some firms have not updated their policies or product approval forms to incorporate and remind associated persons of the requirement to consider reasonably available alternatives. This was even the case for firms with associated persons whose compensation came almost exclusively from alternative investments.

Certain firms had no procedures regarding how costs should be considered when recommending a product. Certain other firms included brief instructions on considerations to include in the explanation, such as the consideration of costs, but these firms also approved transactions where no consideration of the costs of the recommended product was included in the explanation.

[14] Id. at 33,382.
[15] Id.

Regarding the above examples, the Committee notes that the SEC, in support of its position that product-level fees may be disclosed in standardized and not particularized terms, believed the approach to be bolstered by the complimentary obligations.

> 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.[16]

In fact, costs were specifically elevated by the SEC to the text of Reg BI so that it must always be understood and considered by the broker-dealer prior to recommending a securities transaction, underscoring the importance of this consideration.[17]

In addition to concerns under the Care Obligation, the consideration of costs, including compensation to the firm and its associated persons, is also applicable to the Conflict of Interest Obligation.

***Disclosure Obligation***

Under Reg BI, a broker-dealer, prior to or at the time of the recommendation, must provide to the retail customer, in writing, full and fair disclosure of all material facts related to the scope and terms of the relationship with the retail customer and all material facts relating to conflicts of interest that are associated with the recommendation. Importantly, material facts specifically include costs and fees, and the type and scope of services, including any material limitations on securities that may be recommended to customers.[18]

Some of the state exam findings relevant to the Disclosure Obligation that the Committee noted were as follows:

- Use of the term “advisor” or “adviser” by dually registered firms, even for associated persons that are not dually registered as an investment adviser representative and broker-dealer agent (This is a presumptive breach of the Disclosure Obligation.);[19]
- Use of confusing boilerplate and complex financial jargon regarding fees and costs that reasonable retail customers would likely have difficulty deciphering (contrary to SEC direction that firms provide “full and fair” disclosure in “plain English”);[20]

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[16] Id. at 33,356.
[17] Id. at 33,372–74.
[18] Id. at 33,347, 33,354, 33,356.
[19] Id. at 33,350–55.
[20] Id. at 33,364–33,366, 33,368; Proposed Rule: Regulation Best Interest, Exchange Release No. 34-83062, (April 18, 2018), 83 Fed. Reg. 21,574, 21,604–05, 2018 WL 2114081 (May 9, 2018).

- Failure to document or require documentation ensuring the delivery of the primary disclosure document or Form CRS to customers (presumptive breach of Compliance Obligation);[21]
- Failure to disclose the anticipated amount of the up-front sales commission or the material risks associated with a product at the time of the recommendation, outside of the Form CRS and product prospectus (Mutual funds were the only product for which a majority of examined firms specifically disclosed the amount of anticipated sales commissions at the time of the recommendation.);
- Failure to disclose financial incentive conflicts associated with recommendations of a non-traded REIT or private placement, outside of disclosures contained within the Form CRS and product prospectus (unclear explanations regarding third-party compensation from product sponsors).

Examined firms continued to rely heavily on prospectus disclosure. While the SEC Adopting Release generally allows for layered disclosure and flexibility in the disclosure of product-level fees,[22] with respect to the material facts regarding conflicts of interest, the SEC Adopting Release states that additional details regarding many conflicts need to be disclosed as material facts relating to the conflict.[23] The Committee has concerns that this cannot be satisfactorily achieved through the product prospectus.

For example, although a product prospectus could reference due diligence reallowances or marketing fees payable to certain participating broker-dealers, these statements are generalized and don't necessarily disclose the magnitude of the compensation and often indicate discretion in paying such compensation to broker-dealers (i.e. the issuer or managing broker-dealer *may* pay such compensation). The Phase II (B) exams found that firms were actually receiving such compensation while relying on these vague prospectus disclosures to satisfy the requirement to disclose material facts about a realized conflict of interest.[24] The SEC has taken enforcement actions against investment advisers receiving compensation from mutual fund companies that only disclosed that the adviser may receive such compensation, when in fact they were receiving 12b-1 fees, finding this to be inadequate disclosure.[25]

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[21] Reg BI Adopting Release, 84 Fed. Reg. at 33,398–401.
[22] Id. at 33,371.
[23] "[F]or example, to the extent fees and costs incurred related to these product, s create conflicts of interest associated with a recommendation, [the SEC] believe[s] 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." Id. at 33,356.
[24] "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." Id. at 33,363.
[25] SEC, Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation, (October 2019), https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation; Id. at footnote 13.

Finally, half of examined firms, including those with procedures addressing the duty to consider reasonably available alternatives, have no formal policy to affirmatively discuss lower-cost and lower-risk options available within the firm with retail customers at the time of the recommendation of the security. For non-traded REITs and private placements, specifically, the percentage is significantly lower. The Committee is concerned that firms do not consider it material to disclose to their customers the products that were considered but not ultimately recommended to them.

***Conflict of Interest Obligation***

The Conflict of Interest Obligation was adopted 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.[26]

Conflicts of interest required to be mitigated include 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. Such instances include the ability of the associated person to recommend a higher commission paying product. Furthermore, 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 must be eliminated.[27]

In addition to the above examples regarding disclosures of material facts about conflicts of interest, the Phase (II) B exams focused on mitigation efforts, especially those efforts in place to deter associated persons from steering customers toward higher cost products. Higher compensation available to associated persons presents the greatest incentive for associated persons to place their own interests ahead of their customers.

Examination findings related to the Conflict of Interest Obligation included the following:

- Certain firms had procedures that generally acknowledged the Conflict of Interest Obligation and the requirement to establish, maintain, and enforce written policies and procedures reasonably designed to identify conflicts of interest, but the procedures did not contain information on how the firm identifies conflicts, nor did the firm have a list of conflicts, such as a conflict register or matrix;
- Other firms that generally acknowledged the Conflict of Interest Obligation had no procedures to mitigate conflicts of interest of an associated person potentially recommending a higher commission product and placing their own interest ahead of the customer's interest;
- The only mitigation step in place for a vast majority of firms was limiting the types of customers to whom a product may be recommended. Many firms limited the types of customers eligible to purchase alternative investments by having

[26] Reg BI Adopting Release, 84 Fed. Reg. at 33,385.
[27] Id.; 17 C.F.R. § 240.15*l*-1(a)(2)(iii)(D).

concentration limits, but these firms did not create any policies and procedures addressing the obligation to mitigate. In fact, the concentration limits were in place prior to Reg BI or otherwise appeared coincidental to mitigating the conflict of interest.

While the SEC Adopting Release acknowledged that firms are most capable of identifying and addressing these conflicts and reducing their potential effect on customers, and that firms have flexibility to determine mitigation steps and the reasonableness of procedures is measured against the firm's business model,[28] essential to this discussion is the affirmative requirement to establish policies and procedures regarding mitigation of these conflicts.

For certain firms that did have procedures addressing the requirement to mitigate the aforementioned conflicts of interest, the procedures were not reasonably designed to mitigate the conflict. One firm did little more than paraphrase the SEC Adopting Release examples of potential methods to mitigate the conflict. The firm did not create specific procedures for its associated persons or supervisors to implement any of the possible mitigation measures.

Another firm, which was engaged in sales of non-traded REITs and private placements, had established procedures with a specific section regarding its mitigation of conflicts of interest. However, these procedures did not include mitigation efforts for all conflicts, such as high commission products, but instead were limited to mutual fund share classes, IRA rollovers, and selecting among account types (brokerage or advisory). This example could underscore the importance of expanding regulatory technology (RegTech) tools to include alternative investments and cross-product analysis.

Overall, the policies and procedures reviewed during the Phase II (B) exams suggest that firms are taking a position that, along with general supervision, the firms can limit mitigation measures to disclosures in the Form CRS and other supplemental documents regarding the incentive for agents to potentially recommend high-commission products. However, this approach is misguided. While the SEC Adopting Release indicates that disclosure and compliance with existing supervisory requirements might be sufficient,[29] the SEC Adopting Release also states that more stringent mitigation measures may be appropriate when the compensation is built into the price of the product or when dealing with a complex product.[30] Furthermore, the SEC notes in the January 2023 SEC Risk Alert "Observations from Broker-Dealer Examinations Related to Regulation Best Interest," that disclosure alone does not satisfy the Conflict of Interest Obligation for these types of conflicts.[31]

[28] Reg BI Adopting Release, 84 Fed. Reg. at 33,385–87.
[29] Id. at 33,392.
[30] Id. At 33,391.
[31] SEC, Observations from Broker-Dealer Examinations Related to Regulation Best Interest, (January 2023), https://www.sec.gov/file/exams-reg-bi-alert-13023.pdf.

## Best Practices

The Phase II (B) exams identified a number of firms that had implemented policies and procedures and were engaged in practices aligned with best interest expectations in certain areas. The Committee believes the following policies and practices are beneficial to customers and encourages firm's adoption as a best practice:

- Investor profile forms that collect all key investor data, including investor debt and education;
- Incorporating the Reg BI standard throughout the firm's written supervisory procedures. Exams revealed procedures discussing the best interest standard in regards to each product type offered by the firm with specific policies and procedures on how the standard is applicable to that product;
- Using product-and-cost-comparison tools;
- Obtaining clear written documentation explaining which lower-cost and lower-risk alternatives were considered as "reasonably available alternatives" by the firm and why those alternatives were rejected in favor of higher-cost and/or higher-risk products;
- Applying heightened scrutiny to verify the accuracy of customer profile information listed across multiple forms when the firm has imposed investment limitations, such as concentrations in the product type or a required risk tolerance or investment objective. Exams found instances where firm supervisors are identifying information on an alternative investment form that does not match information on the customer profile form. The exams also identified instructions in the written supervisory procedures on how supervisors should address conflicting information on the customer profile form and the opening account documents for an alternative investment. Steps included requiring new documentation to address potential liquidity concerns prior to approval;
- Incorporating customer profile information beyond net worth into limitations for investing in alternative investments. Certain forms use a matrix that incorporates customer profile factors such as age, risk tolerance, and investment objective into the determination of the maximum percentage of the customer's net worth allowed to be invested in a product, product type, or total illiquid holdings at the firm;
- Creating product-specific disclosure documents to disclose material facts. The Committee identified firms that created a one-page document for certain products, such as structured products or leveraged and inverse ETFs, that highlight material risks of the investment. These standalone forms were clearer and more specific than other alternative investment disclosures that disclosed more generalized risks and were located in the final pages of a multi-page document that contains a number of client acknowledgments;

- Making clear point-of-sale disclosure of all material fees and costs that apply to the recommendation under consideration. For example, one examined firm used an alternative investment worksheet that an associated person completed along with the customer at the time of the recommendation. The worksheet listed the estimated commission amount directly underneath the purchase amount. An estimated commission allows for the associated person to use a simple calculation to determine the amount based on the purchase amount and avoids any concerns referenced in the SEC Adopting Release that identifying fees with particularity is difficult to calculate and prone to errors;[32]
- Clearly identifying third-party compensation arrangements. Certain firms make available within a specifically labeled page on their website the exact amount, percentage, or percentage range, by product, that the firm receives from product sponsors in connection with sales or total customer assets. Some firms even list the product sponsors with whom they have relationships;
- Taking proactive steps to identify conflicts of interest in products and services. Certain firms formed conflicts committees to review the firm's business lines and practices to identify potential conflicts of interest. Other firms incorporated conflict determinations within initial product-level due diligence;
- Developing conflict registers or other methods to document conflicts of interest and how each conflict is resolved (i.e. disclosed, mitigated, or eliminated); and
- Making conflict avoidance the default policy and implementing reward-centric mitigation strategies for remaining financial incentive conflicts. For example, the Committee identified a lower payout by a firm to associated persons for sales of alternative investments that often pay higher commissions so that the actual compensation to the associated person was more level across product lines.

## Presumptive Breaches and Opportunities for Improvement

Certain Reg BI provisions set out clear requirements such that failures to comply are presumptive breaches that constitute a deficiency that should be identified on an exam and cured by the firm. Other Reg BI requirements are more principles based and may be fact sensitive. The Committee recommends that firms avoid conduct that would likely be considered a breach and think twice before engaging in practices that could be deemed inconsistent with Reg BI.

***Presumptive Breaches***

States would generally view the following forms of conduct as presumptive breaches of Reg BI:

- Failure to timely file a proper Form CRS;

[32] Id. at 33,355.

- Failure to supplement the Form CRS with detailed disclosure of fees, costs, and conflicts associated with recommendation prior to or at the time of the recommendation (commonly contained in Supplemental Reg BI Disclosures);
- Improper use of the adviser/or title;
- Continued use of time-sensitive, product-specific sales contests;
- Failure to adopt policies and procedures reasonably designed to identify, eliminate, or mitigate conflicts of interest; and
- Failure to adopt policies and procedures reasonably designed to achieve compliance with Reg BI as a whole.

***Opportunities for Improvement***

The Committee believes the following practices could be harmful to customers as they tend to place the financial interests of firms and brokers ahead of client interests. As such, these policies and practices could be deemed inconsistent with Reg BI. Firms engaging in these practices should be able to explain how the practice is in the best interest of customers. Some states might issue a formal deficiency or take such other action as they deem appropriate on account of these practices. These include:

- Continued use of sales contests, quotas, and bonuses of any type where it is reasonable to conclude that the incentive motivates the firm or associated persons to push certain securities or certain types of securities;
- Layered financial incentives that exacerbate rather than mitigate potential harm to customers;
- Failure to discuss lower-cost and lower-risk alternatives to customers when recommending a complex, costly, and risky product (might also be considered a fraudulent omission as well); and
- Unwieldy, lengthy boilerplate disclosures that do not put investors on fair notice of fees, costs, risks, and conflicts associated with the recommendation under consideration.

## Conclusion

States continue to conduct broker-dealer examinations that include a focus on Reg BI compliance and CCR considerations. Accordingly, additional guidance and examination information may be released as it becomes available. Additionally, as states begin adopting their own regulations that incorporate Reg BI principles, more will be issuing deficiency letters with specific citations to these regulations and, potentially, bringing regulatory enforcement actions. The Committee encourages firms to take note of findings and examples in this Phase II (B) Report and to review their own forms, procedures, and supervisory practices to ensure compliance with Reg BI principles.

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