



## How Reg BI Is Changing Our Business

The SEC's new best interest standard, Reg BI, will change how we do business. Here's what you need to know.

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The Regulation Best Interest Rule (Reg BI), which has a compliance date of June 30, 2020, establishes a new standard of conduct for broker/dealers and their associated persons (advisors). Specifically, it pertains to recommendations made to retail customers relating to securities or investment strategies involving securities. But what does that mean, and how will it affect the way we do business?

### **Background on Reg BI, Form CRS, and Related Interpretations**

Reg BI was part of a rulemaking package released by the SEC on June 5, 2019. The companion releases included the Form CRS Relationship Summary rule, as well as the SEC's interpretations regarding the standard of conduct for investment advisers and the broker/dealer exclusion. Together, according to the SEC, the two rules and two

interpretations were “designed to enhance the quality and transparency of retail investors’ relationships with investment advisers and broker-dealers, bringing the legal requirements and mandated disclosures in line with reasonable investor expectations, while preserving access (in terms of choice and cost) to a variety of investment services and products.”

The general obligation of Reg BI states, “When making a recommendation of a securities transaction or investment strategy to a retail customer, a broker must act in the retail customer’s best interest without placing his or her own interests ahead of the customer’s.” There are two critical terms here:

- **Recommendation:** This is a call to action—or inaction—in the case of a hold recommendation—regarding securities or investment strategies. The more you tailor a communication to a specific customer or target group, the greater the likelihood the communication will be viewed as a “recommendation.”
- **Retail customer:** A retail customer is defined as “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; and (B) uses the recommendation primarily for personal, family, or household purposes.” The definition of retail customer does not include nonnatural persons (e.g., corporations and institutions), but it does apply to high-net-worth clients who may be excluded from FINRA’s suitability rule.

Now that we’ve covered the general obligation of Reg BI, let’s dive deeper into the details.

**Breaking Down the 4 Components of Reg BI**

The general obligation is satisfied only if a broker/dealer and its advisers comply with the four specified component obligations of Reg BI: Disclosure Obligation, Care Obligation, Conflict of Interest Obligation, and Compliance Obligation.

**1) Disclosure Obligation.** The Disclosure Obligation requires us to provide customers, in writing, with full and fair disclosure of all material facts about conflicts of interest relating to the recommendation. It must include

the capacity in which you’re making the recommendation, material fees and costs the customer will incur, and the type and scope of services provided, including any material limitations on securities or investment strategies you may recommend.

Fortunately, these disclosures can be layered, and we can rely on existing disclosure documents. Form CRS serves as the first layer of disclosure and includes general information regarding the types of costs and fees a client may expect. But, this level of disclosure isn’t specific enough to comply with the Disclosure Obligation of Reg BI on its own. With Form CRS serving as the most general layer of disclosure, other disclosures that exist today provide information at a more granular level.

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Examples of existing documents include product-offering documents (prospectuses, private placement memorandums, offering circulars), client agreements (the Master Services Agreement, account forms, and applications), point-of-sale disclosure forms (annuity processing forms, the Alternative Investment Processing Form, switch forms), and trade confirmations. What is missing, however, is a document that connects the high-level disclosure of Form CRS to the particular disclosures found in existing materials. To fill this gap, Commonwealth has created the Investor Disclosure Brochure, where a customer can find more information about the services provided by Commonwealth and access detailed information regarding fees, costs, and conflicts.

The goal of the Investor Disclosure Brochure is to provide enough relevant information to customers, written in plain English and in an easy-to-digest format, so they’re not bogged down with extensive documents or comprehensive legal language. In addition to the firm-level disclosures, advisers will be expected to disclose their own conflicts of

interest. Therefore, as of June 30, 2020, you will be required to deliver the ADV Part 2B to all clients, not just advisory clients. We are working on a supplemental document that advisers with limitations can use with clients to better describe such limits. A limit may include an IAR-only advisor who is limited to providing products and services available through the Commonwealth RIA and not able to provide commission-based brokerage products and services.

**2) Care Obligation.** The Care Obligation is often described as “suitability plus.” This component requires you to take costs, reasonably available alternatives, and factors in the customer’s investment profile into consideration when making a recommendation. It also expands on FINRA’s suitability rule. Although both rules apply to recommendations of securities and investment strategies involving securities, the Reg BI Care Obligation also applies to account-type recommendations (e.g., brokerage versus advisory) and rollovers.

Commonwealth will continue to take a commonsense, risk-based approach to documentation requirements. For example, when you make a recommendation for a product that aligns with the client’s objectives—and the security is not considered complex or illiquid and does not represent a significant portion of the client’s investable net worth—the reasoning behind the recommendation may be self-evident when coupled with his or her investment profile.

On the other hand, if you recommend that a client roll assets over from an employer-sponsored plan to an IRA or to purchase a product that would be considered complex—such as a nontraded alternative, variable or indexed annuity, daily reset, or buffered product—you must maintain additional documentation. Your documentation should capture the rationale behind the recommendation and include a consideration of cost, fees, and reasonably available alternatives. Because of the heightened regulatory focus surrounding rollover recommendations, Commonwealth is developing a mandatory process for capturing the additional documentation needed.

**3) Conflict of Interest Obligation.** This obligation is more applicable to Commonwealth than to its advisers. It requires us to establish reasonably designed policies and procedures to identify, eliminate, mitigate, and disclose

conflicts of interest. We must address conflicts that exist between us and your clients, as well as you and your clients. Once identified, conflicts will need to be eliminated, if possible. If elimination is not possible, the conflict must be mitigated and disclosed. The disclosure of conflicts ties in with the Disclosure Obligation of Reg BI, which applies to Commonwealth and its advisers.

**4) Compliance Obligation.** This obligation requires Commonwealth to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI’s general obligation and separate component obligations.

**Form CRS Relationship Summary Rule**

Reg BI is a standard of conduct that applies to broker/dealers and their advisers, while the Form CRS Relationship Summary rule applies to broker/dealers and SEC-registered investment advisers. Unlike Reg BI, Form CRS doesn’t apply only when making a recommendation.

**Dual/hybrid advisers.** If you are associated with Commonwealth as broker/dealer (dual or hybrid advisor), you must deliver the Investor Disclosure Brochure along with Form CRS, and they must be delivered before or at the time of a triggering event. These events include:

- A recommendation of an account type (brokerage versus advisory; rollovers), a securities transaction, or an investment strategy involving securities
- Placing an order for a retail investor
- Opening a brokerage account for a retail investor

**IAR-only advisers.** If you only associate with Commonwealth’s RIA (IAR-only), you must deliver Form CRS before or at the time you enter into an investment advisory contract with a client. IAR-only advisers do not need to deliver the Investor Disclosure Brochure. The relevant disclosures that relate to investment advisory business are included in the Form ADV Part 2A.

**RIA-only advisers.** If you affiliate as RIA-only, you need to deliver Commonwealth’s Form CRS if your client opens an account with Commonwealth as the broker/dealer of record or is utilizing one of Commonwealth’s investment advisory services, such as Preferred Portfolio Services® (PPS) Custom or PPS Select.

**Commonwealth requirements.** Commonwealth will have one Form CRS, which we are required to file with the SEC and post on our public website. We will conduct a mass-mailing of Form CRS to existing clients in June 2020. The format and content requirements put forth by the SEC are very prescriptive; it must be written in plain English and can be no longer than four pages. It also must include:

- An introduction
- A description of available relationships and services
- Fees, costs, conflicts of interest, and standard of conduct
- Disciplinary history
- Any additional information
- Mandatory conversation starter questions throughout the document

As you think about the requirements of Form CRS, it might be helpful to keep its purpose in mind: it serves as the first layer of disclosure to the client or prospective client; it provides a reader the ability to compare products and services available at the firm; and, since the document format is so rigidly designed, a reader should be able to compare products, services, costs, fees, and conflicts of interest from one form to another.

### Making Sense of It All

There are many moving parts to Reg BI and its companion pieces. Over the past 12 months, tremendous time and effort has been spent establishing and updating policies and procedures, as well as processes and controls. By the time this article is published, you should have completed your Reg BI training. That stated, with the Reg BI compliance date of June 30, 2020 approaching fast, you may still have questions. There is a wealth of useful information on the Regulation Best Interest/Form CRS page on COMMunity Link® (available at My Practice > Compliance > Regulation Best Interest). Of course, if you need additional help, please feel free to reach out to me or someone from my team.



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