

A New Standard for Broker Recommendations

The Commission resolved a long simmering issue by a 3-1 vote, adopting Regulation Best Interest which details the standard applicable when a broker-dealer or registered representative makes a recommendation to a retail customer. While the regulation was proposed in April 2018 and modified in adoption, the debate about the governing standard has continued for a much longer period. The question of whether to adopt the fiduciary duty standard of an investment adviser, the requirements of ERISA or perhaps a new and different standard has been difficult.

While the adopting release is lengthy and complex ([here](#)), the Regulation is built on four basic principles.

First: The Disclosure Obligation. Prior to, or when making a recommendation, the broker-dealer or registered representative “must disclose, in writing, all material facts about the scope and terms of the relationship with the customer.” This includes disclosure of the capacity in which the broker is acting, material fees and costs that will be incurred, the services to be provided and any limitations. The broker must also disclose all material conflicts.

Second: The Care Obligation. This obligation requires that the broker “exercise reasonable diligence and care and skill when making a recommendation to a retail customer.” Before making a recommendation the broker-dealer must consider and evaluate the recommendation and alternatives. The Release makes it clear that compliance with this obligation must be assessed as of the time the recommendation is made, not with hindsight.

Third: The Conflict of Interest Obligation: While disclosure of material conflicts is required by Obligation One, the subject is revisited here. Under this obligation the broker-dealer is required to establish, enforce and maintain reasonably designed written policies and procedures that address conflicts of interest associated with recommendations to retail customers. These policies and procedures must be designed

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to identify all conflicts and mitigate those that create an incentive for the broker to put the interests of the firm ahead of the those of the retail customer. They must also 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: The Compliance Obligation: The broker-dealer is also required to establish, implement and enforce a second set of policies and procedures. These must be designed to achieve compliance with the Regulation as a whole.

The obligations imposed by the Regulation are limited to those situations when a broker-dealer is making a recommendation. They were crafted “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. The Regulation enhances the obligations of the broker-dealer when making a recommendation, but do not simply adopt those of an investment adviser.

To the contrary, the obligations of the Regulation are specifically focused on the relation between a broker-dealer and a retail customer, according to the Release. They are designed “to help 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 . . .”

In the end, the point is to aid the retail investors decision making process when evaluating investment options. Thus “regardless of whether a retail investor chooses a broker-dealer or an investment advisor (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,” according to the Release. Key to all of this, of course is the implementation of the Regulation.