



RISK ALERT

DIVISION OF EXAMINATIONS

January 30, 2023

Observations from Broker-Dealer Examinations Related to Regulation Best Interest*

I. Introduction

Regulation Best Interest established a new, enhanced standard of conduct under the Securities Exchange Act of 1934 (“Exchange Act”) for broker-dealers (“broker-dealers” or “firms”) and associated persons that are natural persons (“financial professionals”) of a broker-dealer when making recommendations of securities transactions or investment strategies involving securities (including account recommendations) to retail customers.¹ After Regulation Best Interest’s June 30, 2020 compliance date, the Division of Examinations started conducting broker-dealer examinations to assess compliance with Regulation Best Interest.² Moving forward, the Division intends to incorporate compliance with Regulation Best Interest into retail-focused examinations of broker-dealers, particularly those that include sales practices within the scope of the examination.³ The Division is issuing this risk alert to highlight deficiencies noted during examinations conducted, as well as examples of weak practices that could result in deficiencies. It is intended to assist broker-dealers in reviewing and enhancing their compliance programs related to Regulation Best Interest.

* This Risk Alert represents the views of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the “Division”). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the “SEC” or the “Commission”). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by Division staff and is not legal advice.

¹ On June 5, 2019, the Commission adopted Rule 15l-1 (“Regulation Best Interest”) under the Exchange Act, which had a compliance date of June 30, 2020. Exchange Act Release No. 86031 (June 5, 2019) (“Adopting Release”), available at <https://www.sec.gov/rules/final/2019/34-86031.pdf>. For additional information on Regulation Best Interest, see <https://www.sec.gov/regulation-best-interest>.

² Initial examinations focused on whether firms established written policies and procedures reasonably designed to comply with Regulation Best Interest and whether firms made reasonable progress in implementing those policies and procedures. See The Division of Examinations, “Risk Alert – Examinations that Focus on Compliance with Regulation Best Interest” (Apr. 7, 2020), available at <https://www.sec.gov/files/Risk%20Alert-%20Regulation%20Best%20Interest%20Exams.pdf>. Subsequent examinations focused on the specific requirements of the rule and included enhanced transaction testing designed to examine whether broker-dealers implemented effectively their written policies and procedures. See “Statement on Recent and Upcoming Regulation Best Interest Examinations from the SEC Division of Examinations” (Dec. 21, 2020), available at <https://www.sec.gov/news/public-statement/examinations-regulation-best-interest-2020-12-21>. This Risk Alert contains observations from both initiatives.

³ See, e.g., [2022 Examination Priorities](#).

II. Legal Background

Regulation Best Interest generally provides that when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, a broker-dealer and its financial professionals must act in the best interest of the retail customer at the time the recommendation is made, without placing their own financial or other interest ahead of the retail customer's interest.⁴ Regulation Best Interest requires compliance with four component obligations: (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 ("Disclosure Obligation"); (2) exercising reasonable diligence, care, and skill in making the recommendation to, among other things, understand the potential risks, rewards, and costs associated with a recommendation, and having a reasonable basis to believe that the recommendation is in the best interest of a retail customer ("Care Obligation"); (3) establishing, maintaining, and enforcing written policies and procedures reasonably designed to identify and address conflicts of interest ("Conflict of Interest Obligation"); and (4) establishing, maintaining, and enforcing written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest ("Compliance Obligation").⁵

III. Staff Observations Regarding Compliance with Regulation Best Interest

Below are examples of deficiencies and weaknesses observed by Division staff during examinations for compliance with Regulation Best Interest.

Compliance Obligation

The Compliance Obligation requires broker-dealers to establish written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest, including the Disclosure Obligation and the Care Obligation.⁶ Staff observed instances in which broker-dealers did not have adequate written policies and procedures required by the Compliance Obligation. Staff observed multiple instances of generic written policies and procedures that were not tailored to the firm's business model or otherwise were limited to restating the rule's requirements. More specific observations include:

- *Policies and Procedures to Comply with the Disclosure Obligation.* Some broker-dealers did not have written policies and procedures reasonably designed to achieve compliance with the Disclosure Obligation. Examples of policies and procedures that may contain deficiencies or weaknesses include policies and procedures that:
 - Did not specify when disclosures should be created or updated (*i.e.*, when the disclosures contain materially outdated, incomplete, or inaccurate information) or how the updated disclosures should be delivered to retail customers. For example, some policies and procedures did not identify the parties responsible for

⁴ Rule 15l-1(a)(1).

⁵ Adopting Release at 13-14.

⁶ Compliance failures related to the Conflict of Interest Obligation are discussed separately below.

creating or updating disclosures, how to identify that material changes have occurred, or when material changes should result in new or updated disclosures.

- Did not have a process to demonstrate that disclosures had been provided to retail customers, making it difficult for the firm to have effective controls to review whether disclosures had been provided prior to or at the time of the recommendation.⁷
- *Policies and Procedures to Comply with the Care Obligation.*⁸ Some broker-dealers did not have written policies and procedures reasonably designed to achieve compliance by their financial professionals with the Care Obligation. Examples of policies and procedures that may contain deficiencies or weaknesses include policies and procedures that:
 - Directed financial professionals to consider reasonably available alternatives without providing any guidance as to how to do so (*e.g.*, by establishing the scope of alternatives to consider or systems to use for considering reasonably available alternatives in formulating a recommendation).
 - Directed financial professionals to consider costs without providing any guidance as to how to do so (*e.g.*, how to consider costs when making a recommendation, what types of costs to consider, including direct and indirect costs, or what systems to use to analyze costs in formulating a recommendation).
 - Created systems that allowed financial professionals to evaluate costs or reasonably available alternatives but did not mandate their use (or, in some instances, firms could not determine whether or not financial professionals used the systems (*e.g.*, because they lacked supervisory review documentation)). Where firms did not mandate use of such systems, the firm could not enforce its policies and procedures that required financial professionals to consider costs and reasonably available alternatives when making recommendations.
 - Directed financial professionals to document the basis for their recommendations but did not give instructions as to when documentation is necessary or appropriate

⁷ See also, Exchange Act Rule 17a-3(a)(35), which requires, 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 Rule 15l-1, as well as the identity of each natural person who is an associated person, if any, responsible for the account.

⁸ In addition to observations on policies and procedures related to the Care Obligation, the staff also observed instances in which broker-dealers were not in compliance with the Care Obligation itself. Whether a recommendation satisfies the Care Obligation is an objective evaluation, turning on the facts and circumstances of the particular recommendation and the investment profile of the particular retail investor, at the time a firm or financial professional makes a recommendation. In general, staff observed instances where broker-dealers or financial professionals failed to understand the recommended product, failed to obtain or consider the customer's investment profile, and failed to understand the potential risks and costs associated with the recommendation. The staff reminds broker-dealers that recommendations to retail customers must comply with Regulations Best Interest, including the Care Obligation.

or the specific information to be gathered, which may make it difficult for the firm to review for compliance with Regulation Best Interest.⁹

- *Policies and Procedures Related to Training and Periodic Reviews and Testing.* When adopting Regulation Best Interest the Commission noted that, depending on the size and complexity of the firm, a reasonably designed compliance program generally would include, among other things, a training program and periodic review and testing.¹⁰ Examples of policies and procedures related to periodic reviews and testing that may contain deficiencies or weaknesses include policies and procedures that:
 - Relied heavily on surveillance systems that existed before the effective date of Regulation Best Interest without considering whether those systems needed modification in order to effectively monitor for compliance with Regulation Best Interest. For example, broker-dealers did not consider whether existing surveillance systems were reasonably designed to prevent violations from occurring, to detect violations that have occurred, and to correct promptly any violations that have occurred with respect to new obligations regarding recommendations of rollovers, account recommendations, and implicit hold recommendations based on monitoring the customer’s account (if the firm has agreed to such monitoring).
 - Relied on documentation maintained locally, rather than in a central location, so that the reviews designed to achieve compliance could only occur during branch examinations. As a result, an extended period could occur before recommendations were reviewed for compliance with the Care Obligation.
 - Relied on surveillance systems that captured only executed transactions to monitor for compliance with Regulation Best Interest. These systems did not capture hold recommendations or recommendations that are not accepted by the retail customer and, as a result, firms were unable to review such recommendations for compliance with the rule.
 - *Employee Training.* Some broker-dealers offered employee training that included information on Regulation Best Interest but did not identify the firms’ processes for compliance with Regulation Best Interest (e.g., the tools or methods that employees could use to comply with Regulation Best Interest). For example, while some broker-dealers required the use of certain systems to evaluate the recommendation, the proper use of the systems was not addressed in the training

⁹ While the Adopting Release noted that the Care Obligation does not require broker-dealers to document the basis for a recommendation, it also stated that broker-dealers may wish to document an evaluation of a recommendation in certain contexts, especially for more complex, risky or expensive products and significant investment decisions, such as rollovers and choice of accounts. The Adopting Release stated that broker-dealers may wish to take a risk-based approach when deciding whether or not to document certain recommendations. Adopting Release at 272-273. See also, question 6 in “Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors” (Mar. 30, 2022), available at <https://www.sec.gov/tm/iabd-staff-bulletin>.

¹⁰ Adopting Release at 360.

or the training did not cover specific firm policies and procedures on Regulation Best Interest.

Conflict of Interest Obligation

Staff observed a number of deficiencies related to the requirement that broker-dealers have written policies and procedures reasonably designed to address conflicts of interest associated with their recommendations to retail customers,¹¹ including:

- *Written Procedures.* Some broker-dealers did not have written policies and procedures reasonably designed to specify how conflicts are to be identified or addressed. For example, the procedure might state that the broker-dealer will identify and address conflicts but did not provide enough detail to establish a structure to identify and address conflicts, such as assigning responsibility to identify and address conflicts to a specific position or unit (*e.g.*, a conflicts officer, a specific unit within compliance, a conflicts committee).¹² In addition, some written policies and procedures did not prohibit sales contests, sales quotas, bonuses, and non-cash compensation that were based on the sales of specific securities or specific types of securities within a limited period of time.¹³
- *Identification of Conflicts.* Some broker-dealers limited the identified conflicts to conflicts associated with prohibited activities (*e.g.*, churning) or used high-level, generic language that did not identify the actual conflict (*e.g.*, “we have conflicts related to compensation differences”) and did not reflect all conflicts of interest associated with the recommendations made by the firm or its financial professionals.
- *Failure to Mitigate.* Some broker-dealers inappropriately relied on disclosure to “mitigate” conflicts that appeared to create an incentive for the financial professional to place its interest ahead of the interest of the retail customer, and did not establish any mitigation measures. However, disclosure alone does not satisfy the Conflict of Interest Obligation for these kinds of conflicts. Rather, the Conflict of Interest Obligation explicitly requires the broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to identify and mitigate (*i.e.*, modify practices to reasonably reduce) conflicts of interest at the financial professional level (*i.e.*, interests that might consciously or unconsciously incline the financial professional to make a recommendation that is not disinterested).

Disclosure Obligation

- *Website Postings.* Some broker-dealers did not satisfy the requirement to provide their disclosures to retail customers in writing where the broker-dealers only posted the

¹¹ For additional information on the Conflict of Interest Obligation, see “Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest” (Aug. 3, 2022), available at <https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest>.

¹² Adopting Release at 315.

¹³ Rule 15l-1(a)(2)(iii)(D).

Regulation Best Interest disclosures on their website or referenced the disclosures in other documents delivered to customers.¹⁴ In these circumstances, providing customers references to disclosures on a website or in another document does not fulfill the broker-dealer’s obligation to deliver the disclosures.¹⁵

- *Registered Representatives Acting in Multiple Roles.* Some broker-dealers have dually licensed financial professionals who are registered representatives, and who also serve as investment adviser representatives.¹⁶ These multiple relationships require disclosures of capacity and may require additional disclosure of conflicts.
 - *Capacity Disclosures.* Some broker-dealers with financial professionals holding multiple licenses failed to establish reasonably designed policies and procedures to ensure that the financial professional was disclosing to retail customers the capacity in which the financial professional was acting. As a result, the staff observed instances where the capacity of the financial professional was not being disclosed to the retail customer prior to or at the time of the recommendation.¹⁷
 - *Conflicts Disclosures.* Some broker-dealers failed to establish policies and procedures reasonably designed to identify the disclosures that should be made with respect to conflicts that are specific to financial professionals that interact with retail customers in multiple capacities. In particular, while some broker-dealers instructed financial professionals to disclose orally any differences from the firm’s standard disclosures, several of these firms provided insufficient guidance for the financial professionals to understand the circumstances under which they need to make additional disclosures (*e.g.*, differences in capacity, material fees and costs, type and scope of services provided, and material facts relating to conflicts of interest associated with the recommendation).¹⁸ Some of these firms also failed to provide guidance regarding how to maintain a record that such oral disclosures were made.¹⁹

¹⁴ Rule 15l-1(a)(2)(i).

¹⁵ As the Commission stated, “the ‘in writing’ requirement could be satisfied either through paper or electronic means consistent with existing Commission guidance on electronic delivery of documents.” Adopting Release at 226. *See also*, Frequently Asked Questions on Regulation Best Interest, third question under the Disclosure Obligation Topic (“I am a broker-dealer; if my Relationship Summary includes a hyperlink to my Regulation Best Interest disclosures, can I satisfy my obligation to deliver the Regulation Best Interest disclosures by delivering Form CRS to new or prospective retail customers?”), available at <https://www.sec.gov/tm/faq-regulation-best-interest#disclosure> (stating that neither Regulation Best Interest nor Form CRS permits a “notice plus access” or “access equals delivery” method of electronic delivery).

¹⁶ Examples include: financial professionals who serve as both a registered representative of the broker-dealer and an investment advisory professional for a dually registered broker-dealer/investment adviser; financial professionals who are employed by a broker-dealer and its affiliated investment adviser; and financial professionals who are employed by a broker-dealer and an unaffiliated investment adviser.

¹⁷ Rule 15l-1(a)(2)(i)(A)(i).

¹⁸ Adopting Release at 140-142.

¹⁹ Adopting Release at 136-139.

IV. Conclusion

To address the issues identified by Division staff in deficiency letters, many broker-dealers modified their practices, policies, and procedures. In sharing these observations, the Division encourages broker-dealers to review their practices, policies, and procedures with respect to Regulation Best Interest in order to address the issues raised in this Risk Alert.

This Risk Alert is intended to highlight for firms risks and issues that Division staff has identified. In addition, this Risk Alert describes risks that firms may consider to: (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
