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The Sale of High Commission Products Under Regulation Best Interest

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Introduction

Regulation Best Interest or, "Reg BI", a new, controversial Rule, went into effect on June 30th, 2020. The Rule, which imposes enhanced and heightened criteria for FINRA member broker/dealers and registered representatives when recommending products, is a measure used by securities regulators to add further protections for U.S. retail investors.

Much effort went into attempting, unsuccessfully, to end the proposed Regulation Best Interest during the rulemaking process because of the additional scrutiny it put on the industry. In comparison, many investors were already of the belief that their registered representatives act in their "best interest" when making investment recommendations. However, the FINRA rules, up to the point of this new regulation, principally required that an investment be "suitable" for the client in order for the broker to recommend the purchase to a public customer.

In our experience, when registered representatives solicit investors to purchase a "complex" investment product, public customers typically rely upon the investment professional to give them advice. Regretfully, many retail investors do not take the time to read the prospectus or private placement memorandum before they agree to the broker's recommendation to purchase a "complex" or high commission product. Accordingly, Reg BI appears to be an attempt to by regulators to protect the investing public by placing a heavier burden on the industry.

The Sale of High Commission Products Under Regulation Best Interest

Rule 151-1 of the Securities Exchange Act of 1934, otherwise known as Regulation Best Interest, mandates that broker-dealers act in the customer's best interest when recommending a security or investment strategy to a retail customer. Generally speaking, the financial interests of the firm must be secondary to the interests of customers. In order to satisfy this heightened standard, brokerage firms must maintain the following responsibilities: (1) Disclosure Obligation; (2) Care Obligation; (3) Conflict of Interest Obligation; and (4) Compliance Obligation. Following each of the foregoing component parts of Reg BI could pose regulatory and compliance hurdles for some FINRA member broker/dealer firms.

With the Rule in its infancy, the application of Reg BI by FINRA and the SEC remains to be seen. However, it is to be expected that smaller, independent broker/dealer firms lacking resources of the wire houses or larger independent firms could face the toughest hurdles. Notwithstanding the additional staff, procedures and systems necessary to remain compliant, "independent" broker/dealer firms will need to analyze their business models and the products they bring or offer on their platform. Still, many questions remain outstanding. For example, how will some firms continue to solicit the sale of high commission products, like some variable annuities, private placements and non-traded REITS, while meeting the "conflict of interest obligation" under Regulation Best Interest? What best practices will help brokerage firms meet new regulatory standards? Finally, how will Reg BI effect customer complaints, arbitration claims and other litigation surrounding such products?

The world of high commission products could face significant change. Recommending the purchase of high-risk, alternative products that pay significant commissions seems like a non-starter under Regulation Best Interest. While the Rule bans certain sales practices such as sales contests, quotas and bonuses, there is no explicit ban on high commission products. However, there is a potential conflict to sell some of these products at the high commission payouts previously accepted in the securities industry. Accordingly, firms may either have to stop selling such products, reduce commissions for these investments or direct additional time and resources in order to comply with the obligations imposed by Reg BI. With respect to the compliance efforts, the heightened best interest analysis promulgated by the new Rule will likely balance commissions against a customer's investment objectives, risk tolerance and other profile information; the higher the commission, the more exacting the balancing act. Either way, firms and registered representatives are likely to lose revenue or profits – either by not selling the products at all, reducing commissions on the products sold or spending more on regulatory and compliance costs associated with the products.

For firms committed to offering these products, reasonable steps to adhere to the new Rule must be taken. Specifically, broker/dealers will need updated and additional written supervisory procedures, beefed up policies, and, possibly, stricter supervision. Procedures will obviously need to include updates relative to the language of the Rule and outline the manner in which registered representatives can meet each of the four component parts of Reg BI. As usual, effective policies and procedures should reasonably lay out precisely how compliance with the Rule will be documented and how supervision will be accomplished. Indeed, broker/dealer "guidelines" without enforcement via reasonable supervision typically lead to systemic failure and potential regulatory issues. Further, broker/dealer policies may have to increase the due diligence process on high commission products. After all, firms should be well-educated on these investments to determine possible risks and potential benefits to justify their sale. In addition, policies related to disclosure will

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become integral to complying with Reg BI. Under the conflict of interest obligation, broker/dealers must mitigate conflicts that incentivize associated persons to place their interests or the interests of the broker/dealer firm ahead of the customer's interests. Higher commissions on an investment product could be precisely the type of conflict that would cause a registered representative to solicit an investor to purchase one investment product over another. Absent completely eliminating conflicts, the Rule makes clear that disclosing conflicts (like high commissions) will help a firm stay in compliance with Reg BI. Yet, in addition to disclosure of conflicts, firms will need to make sure the supervision of this sales activity is reasonable given the facts and circumstances. From our experience with FINRA, the sale of investment products such as private placements to retail investors can draw substantial scrutiny from regulators. Add the new, exacting demands of Reg BI and we anticipate that FINRA and the SEC will be reviewing this portion of a broker/dealer's business strictly. If firms continue to sell high commission products, they must be up to the task and armed with a compliance plan and implementation to meet the increased demands under the new Rule.

In any environment, increased regulation often leads to increased scrutiny from the SEC and FINRA. With the combined influence of the market turmoil caused by the COVID-19 pandemic and other economic factors, firms can anticipate that private litigation and client-based FINRA arbitrations related to the sale of high commission products under Reg BI will likely increase. Claims related to sales of high commission investment products, many of which are illiquid and risky, may be particularly fraught in current market conditions for various reasons, including investors' desire to generate income or to liquidate investments in the face of challenging job market circumstances. Finally, PIABA attorneys are eager to assert aggressive cases after riding out the longest bull market in history. Reg BI potentially gives the plaintiff's securities bar an additional tool.

How can firms mitigate risk and otherwise best defend claims related to Reg BI? For starters, firms should review their business models and conduct a cost/benefit analysis of selling certain types of products such as private placements, non-traded REITS and others. As previously mentioned, there are now new and increased associated costs involved with engaging in this type of business – brokers would be wise to determine if selling certain products continues to make sense for them. If firms do plan to sell high-commission investments, due diligence procedures must be upgraded to ensure that the firm understands the risks and features of each investment offering. And, in addition to normal Reg BI guidance, training related specifically to selling these types of products should be immediately rolled out and then re-emphasized, at a minimum, at annual compliance meetings. Lastly, adherence to written procedures and policies must be maintained because it will pay dividends when claims arise or are threatened.

Defending Reg BI claims will likely be more successful if firms conduct business anticipating future litigation. For example, defending cases is easier when your attorneys have the benefit of a cache of compliance documents related to the sale of the high commission product at issue. These documents should highlight precisely how the firm and its associated persons met each of the four obligations set forth under the new Rule. In addition, a best evidence tool to prove that a registered representative satisfied the conflict of interest obligation is to advise the customer, clearly in writing, of each potential conflict and have the customer execute that form. Further, firms must remain cognizant of the fact that since Reg BI employs a "best interest" rather than "suitability" standard, the compilation of pertinent customer investor information is key. Accordingly, the firm, registered representative and defense counsel will benefit from full and complete customer profile information including, but not limited to: age, investments held outside the firm, investment objectives and risk tolerance, investment experience, investment time horizon, and liquidity needs. Such important client information would be more compelling for the defense if it is in the client's handwriting, a letter or e-mail from the client. Finally, the firm's chief compliance officer and other compliance staff must become quasi-experts of Reg BI through training and continuing education since they will likely be important witnesses at a hearing. While the successful defense of these cases is possible, firms need to anticipate litigation starting now.

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