Speech

A Call to Action: *Recommendations* for Complying with Reg BI
Remarks at the ALI CLE 2021 Conference on Life Insurance Company Products

Commissioner Allison Herren Lee

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Thank you, Steve [Stephen Roth] for that kind introduction. Before I begin, a reminder: the views I express today are my own and do not necessarily represent the views of my fellow Commissioners or the staff.

It's a pleasure to join you today to help kick off your 2021 Conference on Life Insurance Company Products. Your agenda over the next two days is comprehensive and touches on many of the important issues that matter to those who invest in these products. It's great to see so many individuals from the Commission's Divisions of Investment Management, Examinations, and Enforcement on the agenda. The variable insurance products offered and sold by those of you in this room are an important component in the retirement savings of many Americans. On-going dialogue between the Commission and the industry, particularly on issues such as disclosure, conflicts, and sales practices, helps us both to better serve investors.

In that spirit, I want to focus my remarks today on Regulation Best Interest.[1] As Chair Gensler has stated—and as I have expressed before—the Commission intends to work, both directly and together with FINRA and others, to ensure that Reg BI lives up to its name; that is, to ensure that investors receive not merely *suitable* recommendations, but recommendations that are truly in their *best interest*.[2] As you all know, the rule is largely principles-based, and its application should and will be flexible to account for evolution in the market and the needs of investors.[3] Why does this matter? Because, in addition to the many millions of Americans who have long invested their savings through retail brokerages, we are currently witnessing a substantial influx of new, less experienced investors relying on an increasingly high tech brokerage community to navigate the investment process.[4] A number of the largest brokerages are reporting substantial growth in account openings during 2020—by some measures exceeding 10 million new accounts in 2020 alone—and a decrease in the average customer age and account size.[5] Our focus on the needs of retail investors has never been more important.

As the Commission and its staff embark on a new fiscal year and examination cycle, I want to discuss two critical aspects of Reg BI that are relevant to today's audience. First is the scope of what constitutes a "recommendation" and the approach that the Commission should take in interpreting that term under Reg BI. And second is the way in which both the Commission and firms should approach conflicts of interest.

Recommendation: An Evergreen Term for the Evolving Broker-Dealer Landscape

In adopting Reg BI, the Commission sought to ensure that financial intermediaries act in the best interest of retail investors regardless of whether they engage a broker-dealer or an investment adviser. While an adviser's fiduciary obligation applies to the entirety of the advisory relationship, a broker-dealer's obligation under Reg BI applies only at the time that the broker-dealer or its associated person makes a recommendation to a retail customer.

Thus, firms should bring enhanced focus to whether a recommendation has occurred because that is what triggers the enhanced standard of care under Reg BI—and, once triggered, firms must comply with each of the specific component obligations: disclosure, care, conflict of interest, and compliance.[6] The Commission declined to adopt a bright line rule in Reg BI for what constitutes a recommendation, explaining that doing so "could result in a definition that is over inclusive, under inclusive, or both."[7] Instead, the Commission reiterated its belief that a principles-based approach, explicated by existing precedent and guidance, would provide the necessary clarity for determining whether a broker-dealer has made a recommendation.[8]

The Commission's reliance on existing precedent, however, does not mean that the concept of a recommendation is static or that it applies exclusively to facts and circumstances described in past pronouncements. To the contrary, the use of a principles-based framework for determining whether a recommendation has occurred ensures that the application of Reg BI can and will evolve with the broker-dealer community. As the landscape shifts, the Commission can continue to interpret and apply Reg BI in a manner that is both consistent with precedent and designed to protect investors in increasingly modernized markets.

As stated in the Adopting Release for Reg BI, "[f]actors considered in determining whether a recommendation has taken place include whether the communication 'reasonably could be viewed as a call to action' and 'reasonably would influence an investor to trade a particular security or group of securities.'"[9] Moreover, past Commission and FINRA guidance is clear that recommendations to engage in, for example, day trading would constitute a recommendation even if the communication did not mention particular securities.[10] And, as always, the Commission will evaluate the relevant facts and circumstances and the context in which a communication is made in determining whether a recommendation has occurred.[11] Consistent with the Commission's and FINRA's historical approach, those facts and circumstances may include the nature of the broker-dealer's customer base and whether—by reason of age, inexperience, lack of sophistication, or other factors—it may be more likely for the firm's communications to reasonably influence its customers' trading decisions.[12]

Broker-dealers should be thinking critically and carefully about the extent to which nascent practices in the industry may in fact, constitute recommendations. Emerging uses of technology present a clear example of an area that warrants close scrutiny, especially when such technologies are used to engage and communicate with retail customers in a way that is reasonably likely or designed to influence investment or trading behavior, even if such influence is subtle. It is also evident that, in an increasingly commission-free trading environment where broker-dealers generate substantial revenue from payment for order flow, incentives are shifting more and more from recommending particular securities to recommending day trading more broadly, irrespective of the securities traded.

As the Commission stated in adopting Reg BI, the broad scope of what constitutes a recommendation "appropriately recognizes that customers may rely on firms' and associated persons' investment expertise and knowledge, and therefore the broker-dealer should be responsible for [] recommendations, regardless of whether [they] result in transactions or generate transaction-based compensation."[13] And customers may especially rely on their broker's knowledge or expertise when the broker is employing technology to streamline their investing experience. The use of algorithms, prompts, machine-learning, or other forms of technology to generate these communications does not relieve a broker-dealer of its responsibilities under Reg BI. The question is whether these practices may reasonably be viewed as a "call to action" or whether they "reasonably would influence an investor to trade."[14]

Likewise, in light of the regulatory import of making a recommendation, broker-dealers should also reevaluate longstanding practices, such as those related to account opening, to determine whether Reg BI may apply. The Commission's recent experience with the Share Class Selection Disclosure Initiative and other similar cases may be instructive in this respect.[15] In those cases, investment advisers were causing clients to purchase and/or hold mutual fund share classes that were more expensive (but usually more lucrative for the adviser or its affiliates) than otherwise available share classes, including in the context of money market funds used as cash sweep vehicles.[16]

What lessons might be learned from this in the broker-dealer context? Compliance personnel should closely evaluate account opening procedures, to consider whether practices for selecting default account options or presenting or otherwise highlighting a subset of investment options might implicate Reg BI. Depending on the facts and circumstances, the use of a default investment or the presentation of a small subset of investment options on an account opening form may well constitute a recommendation under existing interpretations of that term.

So, let me conclude this section of my remarks with a recommendation of my own: when evaluating the ways in which Reg BI applies to your business, think broadly about your communications with customers—no matter the form—to evaluate whether they might be recommendations.

Conflicts of Interest and Mitigation: An Ounce of Prevention

In addition to the Commission's focus on broker-dealer communications and recommendations, we should continue to emphasize the importance of effective mitigation to address conflicts of interest under Reg BI, both at the firm level and for its associated persons.

By its terms, Reg BI does not expressly require the mitigation of *all* conflicts of interest. Instead, Reg BI's conflict of interest obligation requires that a broker-dealer "identify and at a minimum disclose" all conflicts of interest associated with recommendations.[17] In addition to prohibiting certain sales practices, the rule broadly requires mitigation in two circumstances: (1) when a conflict might cause an associated person to place their own interest ahead of the customer's; or (2) when limitations on the fund's product menu might cause the broker-dealer or its associated persons to place their own interest ahead of the customer's.[18]

Notwithstanding the focus on disclosure for conflicts of interest at the firm level, it is important to reiterate that Reg BI's overarching best interest obligation is not satisfied through disclosure alone.[19] That is, a broker-dealer that is subject to Reg BI has an affirmative obligation to make recommendations in its customers' best interest and cannot simply rely on disclosure to discharge that requirement.[20] Thus, in circumstances where mitigation may not be strictly required by the rule text, the absence of mitigation may well heighten the risk of a tainted recommendation that will violate Reg BI's care obligation.[21] This is especially true when, in light of the communication and other technologies discussed above, it is increasingly common for recommendations to come from the firm itself rather than, or in addition to, its associated persons. Firms should expect close scrutiny of recommendations made in the face of an unmitigated conflict.

Where mitigation *is* specifically called for by the rule text, the requirement necessarily demands steps beyond mere disclosure. The Commission was clear that disclosure alone will not sufficiently reduce the potential effect that certain conflicts may have on recommendations.[22] Broker-dealers must take steps to affirmatively reduce the potential effect of conflicts so they do not taint recommendations.[23] This means our Division of Examinations should focus on firms' efforts at mitigation to ensure that measures are reasonably designed and effective in protecting retail customers. This is also an area where it would be helpful for Exam staff to publish its findings about those practices that are—and are not—effective at achieving this outcome.

In thinking about mitigation, it may be helpful to consider the various contexts in which conflicts arise for a firm's representatives. Some are not affirmatively created by the firm, but rather are built into the products that a firm permits its representatives to recommend (e.g. some products pay higher commissions than others, or make revenue sharing payments when others do not). Some conflicts originate with the firms themselves (e.g. setting quotas, offering bonuses or other rewards, certain hiring incentives, payout grids, etc.). Firms must mitigate *all* of these conflicts, and have various options for doing so. However, a threshold question to ask about an incentive is whether it should be created or permitted at all. Sometimes the best mitigation is simply

to avoid from the outset an inducement that might cause representatives to put their own interests ahead of their customers.

One final note worth mentioning here is something about which I know you are all well aware. The mitigation requirement in Reg BI represents a distinction from NAIC's model regulation for annuity sales.[24] That model, which was designed exclusively for the sale of insurance products, requires only disclosure of the producer's compensation, and explicitly excludes that compensation from the conflicts of interest that require mitigation.[25] Under Reg BI, which applies to the entire range of securities and includes variable insurance products, the Commission came to a different conclusion about the need for and benefits of mitigation. As states continue to adopt and implement the NAIC model, I encourage those of you in the securities and insurance industries to evaluate your policies and procedures to ensure they are consistent with both standards.

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In sum, the Commission remains committed to ensuring that Reg BI elevates the standard of care beyond suitability and that investors receive recommendations that are in their best interest. As the industry continues to change, and as technology increasingly plays a vital role in communicating with and servicing clients, I encourage you to think broadly about when the rule is triggered and how best to deal with all manner of conflicts that arise when Reg BI applies. In that regard, I will leave you with a favorite quote from novelist and social reformer Upton Sinclair: "It is difficult to get a man to understand something when his salary depends on his not understanding."[26] The updated version of that quote, of course, would not be limited to just men. Nevertheless, its wisdom endures and bespeaks prudence and care in addressing conflicts of interest and ensuring that Reg BI lives up to its promise for America's retail investors. Thank you for having me today.

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[1] *See* 17 CFR 240.15*l*-1 ("Reg BI").

[2] We must work to ensure that Reg BI lives up to its name, but we should also be prepared to consider changes to the standard if our experience through examinations and enforcement suggests that changes are warranted. Indeed, as the Commission stated at the time of Reg BI's adoption, "we will continue to monitor the effectiveness of Regulation Best Interest in achieving the Commissions goals." *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Rel. No. 34-86031, 84 FR 33318 (July 12, 2019) ("Reg BI Adopting Release").

[3] *See, e.g.*, *id.* at 33334 ("[C]ompliance with each of the specific component obligations of Regulation Best Interest, including the 'best interest' requirement in the Care Obligation, will be applied in a principles-based manner. This principles-based approach to determining what is in the 'best interest' is similar to an investment adviser's fiduciary duty, which has worked well for advisers' retail clients and our markets. As proposed, whether a broker-dealer has acted in the retail customer's best interest will turn on an objective assessment of the facts and circumstances of how the specific components of Regulation Best Interest are satisfied at the time that the recommendation is made . . . We understand that markets evolve and we encourage broker-dealers to have an open dialogue with the Commission and the Commission's staff as questions arise.").

[4] *See* Staff Report on Equity and Options Market Conditions in Early 2021 (Oct. 14, 2021) at 9-10.

[5] *See id.* at 9-10. *See also* New Army of Individual Investors Flexes Its Muscle, Wall St. J. (Dec. 30, 2020), https://www.wsj.com/articles/new-army-of-individual-investors-flexes-its-muscle-11609329600 (citing estimates that individual investors opened more than 10 million new brokerage accounts in 2020).

[6] Reg BI Adopting Release, *supra* note 2, at 33333 ("The specific component obligations of Regulation Best Interest are mandatory, and failure to comply with any of the components would violate the General Obligation.").

[7] *Id.* at 33335.

[8] *Id.* at 33330.

[9] *Id.* at 33335 (internal quotations omitted).

[10] *Id.* at 33339. *See also* FINRA Regulatory Notice 12-55, Guidance on FINRA's Suitability Rule, at Q7 (Dec. 2012), https://www.finra.org/rules-guidance/notices/12-55 ("Rule 2111 states that the term "investment strategy" is to be interpreted 'broadly' . . . The 'investment strategy' language would apply to recommendations to customers to invest in more specific types of securities, such as high dividend companies or the 'Dogs of the Dow,' or in a market sector, regardless of whether the recommendations identify particular securities. It also would apply to recommendations to customers generally to use a bond ladder, day trading, 'liquefied home equity,' or margin strategy involving securities, irrespective of whether the recommendations mention particular securities.") (internal citations omitted).

[11] *See* Reg BI Adopting Release, *supra* note 2, at 3335 ("[I]n our view, the determination of whether a broker-dealer has made a recommendation that triggers application of Regulation Best Interest should turn on the facts and circumstances of the particular situation and therefore, whether a recommendation has taken place is not susceptible to a bright line definition."). See also FINRA Regulatory Notice 11-02 (Jan. 2011), https://www.finra.org/rules-guidance/notices/11-02 ("The determination of the existence of a recommendation has always been based on the facts and circumstances of the particular case . . . For instance, a communication's content, context and presentation are important aspects of the inquiry. The determination of whether a 'recommendation' has been made, moreover, is an objective rather than subjective inquiry. An important factor in this regard is whether—given its content, context and manner of presentation—a particular communication from a firm or associated person to a customer reasonably would be viewed as a suggestion that the customer take action or refrain from taking action regarding a security or investment strategy."); NASD, Notice to Members 01-23, Suitability Rule and Online Communications (Apr. 2021), https://www.finra.org/sites/default/files/NoticeDocument/p003887.pdf ("[T]he 'facts and circumstances' determination of whether a communication is a 'recommendation' requires an analysis of the content, context, and presentation of the particular communication or set of communications. The determination of whether a 'recommendation' has been made, moreover, is an objective rather than a subjective inquiry. An important factor in this regard is whether—given its content, context, and manner of presentation—a particular communication from a broker/dealer to a customer reasonably would be viewed as a 'call to action,' or suggestion that the customer engage in a securities transaction. Members should bear in mind that an analysis of the content, context, and manner of presentation of a communication requires examination of the underlying substantive information transmitted to the customer and consideration of any other facts and circumstances...").

[12] *See*, *e.g.* Gordon Scott Venters, 51 S.E.C. 292 (Feb. 8, 1993) (observing, in finding (1) that an associated person made a recommendation; and (2) that the recommendation was unsuitable, that the associated person "aggressively promoted [a company's stock] to his *unsophisticated customer* and stating that "[a]t the very least, when [the associated person] learned about *his customer's age and situation*, he had a duty to abandon the promotion in which he was engaged") (emphasis added); F.J. Kaufman and Co. of Va., 50 S.E.C. 164 (Dec. 13, 1989) (rejecting associated person's claim not to have made a recommendation by pointing to, among other things, the fact that one of the relevant customers "had no options trading experience before she opened her first account" and that other customers had no "prior understanding of the margined buy-write strategy", and would not have engaged in the strategy absent the associated person's involvement"). *See also* Michael F. Siegel, Exchange Act Rel. No. 58737 (Oct. 6, 2008) (stating that, in evaluating whether a recommendation has occurred, "sophistication of the investor may be relevant, [but] sophistication alone does not mean that a communication is not a recommendation"); Michael F. Siegel, NASD, National Adjudicatory Counsel (May 11, 2007) (acknowledging that "customers' sophistication may sometimes affect the recommendation issue" and stating that "the discussion ... concerning the customers' sophistication and wealth pertains only to whether a recommendation was made"). Such an approach is also consistent with the Commission's focus on similar factors when evaluating the reasonableness of a broker-dealer's mitigation measures. *See* Reg BI Adopting Release, *supra* note 2, at 33391 ("Reasonably designed policies and procedures should include mitigation measures that depend on the nature and significance of the incentives provided to the associated person and a variety of factors related to a broker-dealer's business model (such as the size of the broker-dealer, retail customer base (e.g., diversity of investment experience and financial needs), and the complexity of the security or investment strategy involving securities that is being recommended), some of which may be weighed more heavily than others. For example, more stringent mitigation measures may be appropriate in situations where the characteristics of the retail customer base in

general displays less understanding of the incentives associated with particular securities or investment strategies[.]")

[13] Reg BI Adopting Release, *supra* note 2, at 33339.

[14] *Id*. at 33335.

[15] *See* Securities and Exchange Commission, Division of Enforcement, Announcement: Share Class Selection Disclosure Initiative (Feb. 12, 2018), https://www.sec.gov/enforce/announcement/scsd-initiative ("SCSDI"). The SCSDI was a self-reporting initiative in which the Division of Enforcement agreed to recommend more favorable settlement conditions to investment advisers that self-reported (than those that did not) violations of the Advisers Act relating to practices involving mutual fund share class selection and related disclosures. As part of the initiative, the Division agreed to limit the charges to violations of Advisers Act Sections 206(2) and 207 for failure to disclose certain conflicts of interest; it also agreed not to recommend civil penalties. Self-reporting advisers generally settled to charges that they violated their duty of loyalty by failing to disclose the conflict of interest associated with recommending mutual fund share classes charging 12b-1 fees. Such fees, which investors are charged directly by the relevant mutual fund, are often paid to the adviser, its IARs, or an affiliated broker-dealer, thus creating an incentive for an adviser or broker-dealer to recommend those share classes. In many instances, advisers recommended the more expensive share class even when a less expensive share class of the same fund was available and presented a more favorable value to the client under the circumstances. For those advisers that did not self-report as part of the SCSDI, the Commission also brought a number of settled and litigated enforcement cases against advisers alleging, in addition to the charges included as part of the SCSDI, that advisers violated Section 206(2) by failing to seek best execution.

[16] See *id*. *See also* Jonathan Roberts Advisory Group, Inc., Advisers Act Rel. No. 5832 (Aug. 25, 2021) (finding that the adviser violated its duty to seek best execution related to cash sweep accounts by, among other things, causing its clients to purchase and/or hold share classes of money market funds that charged higher fees and paid revenue sharing to an unaffiliated broker-dealer even though other share classes of the same money market funds, which charged lower fees and did not pay revenue sharing, were available).

[17] 15 CFR 240.15*l*-1(a)(2)(iii)(A).

[18] *See* 15 CFR 15*l*-1(a)(2)(iii)(B) and (C). *See also* Reg BI Adopting Release, *supra* note 2, at 33326-27.

[19] Reg BI Adopting Release, *supra* note 2, at 33319 ("Regulation Best Interest establishes a standard of conduct under the Exchange Act that cannot be satisfied through disclosure alone").

[20] 15 CFR 240 15*l*-1(a)(2)(ii) (setting out Reg BI's so-called care obligation, which requires, among other things, that a broker-dealer or associated person exercise reasonable diligence, care, and skill to "have a reasonable basis to believe that the recommendation 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."). *See also* Reg BI Adopting Release, *supra* note 2, at 33441 ("Regulation Best Interest is not limited to disclosure; rather, the Disclosure Obligation is just one component of Regulation Best Interest that as a whole will enhance the efficiency of recommendations that broker-dealers provide to retail customers, help retail customers evaluate the recommendations received, and improve retail customer protection when receiving recommendations from broker-dealers. In particular, in addition to the Disclosure Obligation, both the Care Obligation and the Conflict of Interest Obligation, discussed below, are designed to promote more efficient investment decisions by imposing affirmative obligations on the broker-dealer that cannot be fulfilled through disclosure alone, regardless of whether the retail customer fully incorporates disclosed information into its investment decisions.").

[21] *See* Reg BI Adopting Release, *supra* note 2, at 33389 ("[W]e emphasize that pursuant to the overarching obligation, elimination of conflicts of interest is one method of addressing the conflict, in lieu of disclosure, which broker-dealers may find appropriate in certain circumstances even when not required by Regulation Best Interest.").

[22] *Id.* at 33390 (discussing firm-level conflicts in the context of the Conflict of Interest Obligation).

[23] *Id.* at 33390. *See also id* at 33391 ("By requiring that a broker-dealer establish policies and procedures reasonably designed to 'mitigate' these conflicts of interest, we mean the policies and procedures must be reasonably designed to reduce the potential effect such conflicts may have on a recommendation given to a retail customer.").

[24] *See* National Association of Insurance Commissioner (NAIC), Suitability in Annuity Transactions Model Regulation (#275) (Feb. 13, 2020).

[25] *See id.*

[26] Upton Sinclair, *I, Candidate for Governor: And How I Got Licked* (1935).