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With Regulation BI, Are FINRA Rules 2010 and 2111 Dead?

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The purpose of this article is not to painstakingly summarize the 771-page release for Regulation BI (Reg BI) Release No. 34-86031 (the "Release"), nor is this article meant to address any purported fiduciary or non-fiduciary standard. The purpose of this article is to examine a couple of the FINRA rules that are commonly cited in FINRA enforcement matters and to postulate whether those rules may become subsumed or nullified by Reg BI, specifically FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade) and 2111 (Suitability).

We all know that the SEC has approved Reg BI. The SEC is working with FINRA to not only update any FINRA rules that are affected by Reg BI, but also to assist FINRA with implementing procedural changes into both its examination and enforcement processes, as FINRA will have the ability to enforce, and impose sanctions for violations of, Reg BI. The focus of this article will be the potential enforcement aspect of any new FINRA procedures. Note that Reg BI does not create a new private right of action nor right of rescission.

Reg BI and FINRA's Standards of Commercial Honor and Principles of Trade

According to Reg BI, the best interest obligation requires that:

A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, shall act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer. In sum, the client's best interest should always come before the interests of the firm or the salesperson.

The best interest obligation is satisfied if all of the below four obligations are satisfied. Note, however, that "best interest" is not defined in Reg BI; leaving the term quite vague and subject to subjective interpretation. While best interest seems easy to interpret, it will still come down to someone's subjective analysis of the facts and circumstances in a particular situation.

In looking at FINRA Rule 2010, the verbiage in FINRA Rule 2010, Standards of Commercial Honor and Principles of Trade, can be traced way back in the history of the NASD/FINRA, back to Art. III, Sec. 1 of the NASD Rules of Fair Practice, then to Rule 2110 and to the current Rule 2010. The verbiage in all are the same:

"A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."

Similar to the best interest standard, Rule 2010 is quite vague. Over the years, speaking from experience as a former NASD Enforcement attorney, Rule 2010, and its predecessors, has been used as a catch-all violation for many cases where no specific FINRA rule has been identified as being violated. It also has typically been included as an add-on rule violation where other specific rules do apply.

It is my opinion that Reg BI will be used by the SEC like Rule 2010 has been used by FINRA, as a catch-all provision. It does not have the scienter requirement of a Rule 10b-5 fraud allegation and may likely be that mere negligence will be enough for a finding of a violation of Reg BI. What this means is that the volume of SEC cases can increase using Reg BI as a tool. Thus, firms must get their processes in line with both the word and the spirit of Reg BI.

Reg BI and Suitability

Reg BI is not a very long rule; it is pretty straightforward. If you want to skip to the rule itself, jump to page 769 of the Release, read the text of the rule, then go back and read the body of the Release.

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Regulation BI is a point-of-sale regulation. That is, Reg BI is triggered at the time of the recommendation and requires that the best interest of the client be taken into account.

Reg BI has four *obligations*:

Disclosure Obligation: At or before the time of the recommendation, there must be disclosure of fees, costs, services and conflicts must be disclosed to potential clients. The broker, dealer, or natural person who is an associated person of a broker or dealer, prior to or at the time of the recommendation, provides the retail customer, in writing, full and fair disclosure of:

(A) All material facts relating to the scope and terms of the relationship with the retail customer, including:

(i) that the broker, dealer, or such natural person is acting as a broker, dealer, or an associated person of a broker or dealer with respect to the recommendation;
(ii) The material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and
(iii) The type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer; and

(B) All material facts relating to conflicts of interest that are associated with the recommendation.

Duty of Care Obligation: This language is closely aligned with FINRA Rule 2111. The exercise of reasonable diligence, care, and skill must be present when making a recommendation to a retail customer. The broker-dealer must:

(A) Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;

(B) 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;

(C) Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.

Conflict-of-Interest Obligation: The firm must establish, maintain, and enforce written policies and procedures reasonably designed to identify and, at a minimum, disclose or eliminate conflicts of interest.

Compliance Obligation: Firms must establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Reg BI by June 30, 2020.

Under Reg BI's Duty of Care obligation, there must be a reasonable basis for a recommendation, it must be specific to the customer, and quantitative analysis of the trading must be taken into account. In addition, "hold" recommendations are covered when there is an explicit obligation taken on by the firm to monitor the client's account. The Release notes that, in instances where a broker-dealer agrees to provide the retail customer with specified account monitoring services, such an agreement will result in buy, sell or hold recommendations subject to Regulation Best Interest, even when the recommendation to hold is implicit.

Note that firms can disclose to clients that they are not monitoring the client's account. This carve-out begs the question as to whether a transaction completely eliminates any further duty to the client. The Release answers this in the affirmative in that the Release states that the final rule requires that broker-dealers act in the best interest of their retail customers at the time a recommendation is made and imposes no duty to monitor a customer's account following a recommendation. The Release goes on to note that where a broker-dealer voluntarily reviews a client's holdings, this does not create an implied agreement to monitor that account.

FINRA Rule 2111 is triggered *at the time of the recommendation*, regardless of whether a transaction is completed. Rule 2111(a) requires that a broker-dealer "have a 'reasonable basis' to believe that a recommended transaction *or investment strategy* involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member..."

Reg BI will a cover series of transactions, similar to Rule 2111's "investment strategy involving a security or securities" under Rule 2111.03 and 2111.05 (c).

Reasonable Basis Suitability requires that a broker-dealer have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors.

An explicit recommendation to "hold" must comply with Rule 2111, and such recommendation is also subject to Reg BI.

Under Rule 2111, Customer-Specific Suitability requires that a broker-dealer have a reasonable basis to believe the recommendation is suitable for a particular customer based on that customer's investment profile.

Quantitative Suitability requires that a broker-dealer have a reasonable basis for believing that a series of recommended transactions are not excessive and unsuitable for the customer in light of the customer's investment profile. This is a look at the customer's entire portfolio, and also looks at turnover rate, cost-equity ratio, and in-and-out trading.

As can be seen, Reg BI and Rule 2111 track each other fairly closely.

Comparison of Reg BI and Rule 2111:

Reg BI	Rule 2111
Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers.	The reasonable-basis obligation requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors.
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.	A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation. The customer-specific obligation requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile, as delineated in Rule 2111(a).
Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.	Quantitative suitability requires a member or associated person who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule 2111(a).

Are FINRA Rules 2010 and 2111 Dead?

From an enforcement perspective, it may be "easier" for both the SEC and FINRA to bring actions under the undefined best interest of the client standard. FINRA will be able to use Reg BI in conjunction with Rule 2010 whenever a separate specific rule does not cover the activity in question.

Regarding Rule 2111, FINRA may be more likely to bring cases for suitability violations under Reg BI. Reg BI may have made Rule 2111 a non-factor in suitability cases going forward.

What Should Firms Be Doing Now?

Firms should not wait for 2020 to begin to think about how they are going to implement the changes needed to fulfill the requirements of Reg BI. It is no understatement to say that firms will need to review all aspects of their business and compliance programs and, if firms haven't done so already, have in place a process for a top-to-bottom review of conflicts of interest. Firms will need to do a thorough review of all of the firm's business aspects to root out all conflicts of interest and to determine whether the conflicts can be (a) eliminated, (b) mitigated, and (c) if not eliminated, how to fully disclose the conflicts and risks to clients.

Thus, firms should:

- Immediately address Reg BI in its procedures. Update procedures to comply with Reg BI.
- Update new account documentation, if necessary, to ensure the rule is met at the opening of the account, and, if "monitoring" accounts, on an interim basis after opening.
- Create a conflicts of interest matrix to identify the conflicts and risks associated with such conflicts and put a process in place to address the conflicts.
- Train registered representatives, supervisors and compliance staff on the changes.