Handle with Care: Evolving Standards of Care

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The evolving regulation of financial intermediaries—whether broker-dealers, investment advisers, dual registrants or affiliated entities—continues to have a significant impact on regulatory risk programs and compliance infrastructure for private client servicing. The 2019 adoption of Regulation Best Interest ("Reg BI")[2] and the Investment Adviser Interpretation ("Adviser Interpretation")[3] occurred after almost a decade of focus from federal regulators and lawmakers on fiduciary duty and the standards of conduct that should govern the dealings that investment advisers and broker-dealers have with retail investors. SEC enforcement actions pursuant to Reg BI are also expected accelerate in 2024.

[1] This CLE outline was prepared by Armstrong Teasdale LLP in conjunction with preparation for A.Valerie Mirko's participation as moderator of the *Handle with Care: Evolving Standards of Care* panel, which included the following speakers: Gwendolyn Taylor (Benjamin F. Edwards), Lee Thoresen (RBC Wealth Management) and Orit Weinstein (D.A. Davidson).

[2] *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, 84 FR 33318 (July 12, 2019) ("Reg BI Adopting Release").

[3] *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, 84 FR 33669 (July 12, 2019).

Outside the SEC realm, the regulatory emphasis on standards of conduct for financial intermediaries continues with the final April 2024 Retirement Security Rule from the Department of Labor ("DOL").[4] Furthermore, there continues to be more active standards of care engagement, examination and enforcement at the state level. Standards of care that apply to retail and retirement advice are increasingly converging, though with enough differences as to cause a regulatory burden. We address Reg BI, DOL and state developments in this outline, as well as convergence between broker-dealer and investment adviser standards of care considerations.

1. Regulation Best Interest: Rule Text, Adopting Release, Staff FAQs (2020) and Staff Bulletins (2022-2023)

In 2019, Reg BI established a new standard of conduct for broker-dealers when making a recommendation of a securities transaction or investment strategy involving securities (including account recommendations) to a retail customer. The SEC designed Reg BI to "improve investor protection by enhancing the quality of broker-dealer recommendations to retail customers and reducing the potential harm to retail customers that may be caused by conflicts of interest."[5] Although the term "best interest" is not defined in Reg BI, the best interest obligation is satisfied by meeting four component obligations: (a) Disclosure Obligation; (b) Care Obligation; (c) Conflict of Interest Obligation; and (d) Compliance Obligation. Each of these obligations is discussed in more detail below in the order they appear in the rule, though we note that broker-dealers should be considering the Disclosure and Conflict of Interest obligations together.

When broker-dealers were implementing Reg BI, there were FAQs provided toward the end of the implementation period,[6] though it was clear from industry thought leadership and dialogue that many firms sought further specificity. Over the course of 2022 and 2023, the SEC staff issued three staff bulletins that provide further SEC staff guidance on Reg BI in the format of frequently asked questions.[7] The 2022-2023 staff bulletins provide additional guidance on two of the Reg BI Obligations: the Care Obligation and the Conflict of Interest Obligation. There is also a third bulletin focusing on account recommendations, which is governed by the Disclosure Obligation.

The bulletins reiterate the Staff's view that although the application of Reg BI and the investment adviser fiduciary standard may differ, they "generally yield substantially similar results in terms

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[4] *Retirement Security Rule: Definition of an Investment Advice Fiduciary*, 89 FR 32122 (Apr. 25, 2024) (to be codified at 29 C.F.R. § 2510.3-21).

[5] Reg BI Adopting Release at 33321.

[6] SEC, *Frequently Asked Questions on Regulation Best Interest* (last modified Aug. 4, 2020). No new FAQs were issued after 2020.

[7] SEC, *Staff Bulletin: Standards of Conduct for Broker Dealers and Investment Advisers Care Obligation* (Apr. 20, 2023) ("Care Obligation Staff Bulletin"); SEC, *Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest* (Aug. 3, 2022) ("Conflicts Staff Bulletin"); SEC, *Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors* (Mar. 30, 2022) ("Account Recommendation Staff Bulletin").

of the ultimate responsibilities owed to retail investors."[8] Even more than Reg BI and its Adopting Release, the 2022-2023 staff bulletins highlight the convergence of broker-dealer and investment adviser obligations, while also ensuring that Reg BI and the Advisers Act fiduciary duty remain distinct. The bulletins also spend considerable time addressing how associated persons of dually registered broker-dealers and investment advisers recommend brokerage versus advisory accounts. We address these bulletins at times below in our discussion of each Reg BI obligation. Generally, however, the bulletins provide additional granularity.

The Account Recommendation Staff Bulletin reiterates that reasonably available alternatives applies not only to particular securities or investments but also to account types. Factors that have bearing on which kind of account should be recommended would include account minimums, eligibility requirements, services offered, fees imposed, and conflicts of interest embedded in the various kinds of available accounts. The staff bulletins also make clear that the sole determinant relating to recommending a particular kind of account should not be an associated person's limited license.[9] So, for example, if an associated person is not qualified to manage an account in a specific wrap fee program sponsored by the dual registrant, the associated person would need to consider that kind of account notwithstanding that person solely having broker-dealer licensing and therefore being ineligible to manage an adviser wrap account.

(a) Disclosure Obligation

The Disclosure Obligation is an example of how the SEC drew from the Advisers Act and related caselaw to shape the contours of Reg BI, without imposing a fiduciary standard on broker-dealers. As compared to the prior suitability regime, one of the most significant impacts of Reg BI is that it imposes a "more explicit and broader disclosure obligation on broker-dealers than that which currently exists under the federal securities laws and SRO rules."[10] The definition of "conflict of interest" under Reg BI is modeled off of *SEC v. Capital Gains Research Bureau, Inc.*, which describes, with respect to investment advisers, an "interest that might incline an investment adviser—consciously or unconsciously—to make a recommendation that is not disinterested."[11]

(i) Disclosure of Conflicts of Interests

Reg BI requires broker-dealers, prior to or at the time of the recommendation, to provide to the retail customer, in writing, *full and fair disclosure* of all *material facts* related to the scope and terms of the relationship with the retail customer and all *material facts* relating to *conflicts of interest* that are associated with the recommendation. If a broker-dealer agrees to monitor a

[8] SEC, *Staff Bulletin: Standards of Conduct for Broker Dealers and Investment Advisers Care Obligation* (Apr. 20, 2023).

[9] SEC, *Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors*, Question 1.c. (Mar. 30, 2022)

[10] Reg BI Adopting Release at 33346.

[11] 375 U.S. 180, 191-92 (1963).

customer's account, the terms of the account monitoring, including the scope and frequency of those services, must also be disclosed.

- "*Full and fair disclosure*" means giving "sufficient information to enable a retail investor to make an informed decision with regard to the recommendation."[12]
- "*Material facts*" is modeled on the standard set in *Basic v. Levinson*: a fact is material if there is a substantial likelihood that a reasonable retail customer would consider it important.[13] The SEC explicitly requires disclosure, at a minimum:
    - That the broker, dealer or such natural person is acting as a broker, dealer or an associated person of a broker-dealer with respect to the recommendation;
    - Of the material fees and costs that apply to the retail customer's transactions, holdings and accounts; and
    - Of 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.

(ii) Titling Restrictions for Broker-Dealers

It is a presumptive violation of the Disclosure Obligation if a broker-dealer uses the terms "advisor" or "adviser" in a name or title if the broker-dealer is not a dual registrant, or, if an associated person of a broker-dealer uses such terms if the associated person is not supervised by an investment adviser (as well as a broker-dealer).

(iii) Timing and Frequency of Disclosure

The SEC does not provide any specific requirements for the timing and frequency of written disclosures, other than requiring disclosure prior to or at the time of the recommendation. However, the SEC believes it should be made "early enough" to give retail investors ample time to make informed decisions, but "not so early" that the disclosure fails to provide meaningful information. The SEC also recommends that firms repeat or highlight disclosures at the time of recommendation.

Disclosures should be updated when they "contain materially outdated, incomplete, or inaccurate information," and such updates should be made "as soon as practicable," but "no later than 30 days after the material change." Firms are encouraged to supplement/correct via oral disclosure until the written disclosure is updated.

(iv) Form of Disclosure

[12] Reg BI Adopting Release at 33438.

[13] 485 U.S. 224, 231-32 (1988).

Reg BI does not prescribe the format or method of satisfying the Disclosure Obligation (other than that the disclosure be in writing). Broker-dealers have flexibility to provide disclosures in the manner and form they normally provide them (outside the context of Reg BI).

(v) Layered Disclosure

Layered disclosure is permitted. The SEC did not prescribe the method of satisfying the disclosure obligation and instead is allowing broker-dealers to determine how to provide full and fair disclosure. The Form CRS or Relationship Summary and the Disclosure Obligation, while separate obligations, are designed to complement and build upon each other to provide different levels of key information. However, in most instances the Relationship Summary will not be sufficient to satisfy the Disclosure Obligation.

(vi) Relying on Existing Documents

The Disclosure Obligation can be satisfied through existing documents provided to retail customers, such as account opening documents, with a standalone document, or by some combination. The key consideration in determining whether to rely on existing disclosure documents, or whether to include or repeat information from existing customer disclosures (e.g., account agreements, advisory brochures, guides to services, fee schedules, 408(b)(2) disclosures, prospectuses and other offering documents) is the usefulness and ease of understanding for retail customers.

(vii) Electronic Delivery or Website Disclosures

Electronic delivery is permitted, consistent with existing SEC guidance on the use of electronic media. However, broker-dealers must make paper delivery available upon request.

(b) Care Obligation

The Care Obligation comprises three components. When making a recommendation subject to Reg BI, broker-dealers must exercise reasonable diligence, care and skill to meet the following three requirements:

- *Reasonable Basis Prong*: 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;
- *Customer-Specific Prong*: Have a reasonable basis to believe the recommendation is in the best interest of the particular retail customer given the retail customer's investment profile and potential risks, rewards and costs, and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer; and
- *Series of Transactions Prong*: 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.

(i) Reasonable-Basis Prong

The first component, which was intended to enhance broker-dealers' existing "reasonable-basis suitability" obligations under FINRA rules, requires that broker-dealers understand the particular security or investment strategy recommended. The SEC noted that "[w]ithout establishing such a threshold understanding of its particular recommended security or investment strategy involving securities, [it] do[es] not believe that a broker-dealer could, as required by Regulation Best Interest, have a reasonable basis to believe that it is acting in the best interest of a retail customer when making a recommendation."[14]

The determination of what would qualify as reasonable diligence, care and skill regarding reasonable-basis suitability depends mostly on "the complexity of and risks associated with the recommended security or investment strategy and the broker-dealer's familiarity with the recommended security or investment strategy."[15] In this vein, broker-dealers should "apply heightened scrutiny" to determine whether recommending complex and/or risky securities and investment strategies would be in a retail customer's best interest.[16] Initial examinations and enforcement efforts by the SEC staff indicate a focus on due diligence practices of broker-dealers, while the Care Obligation Staff Bulletin also includes some mentions.[17]

(ii) Customer-Specific Prong

The second component focuses on individual customers and requires that broker-dealers apply their understanding of a particular securities transaction or investment strategy to determine whether it would be in the best interest of a particular retail customer based on their understanding of the potential risks, rewards and costs of the recommendation, and in light of the retail customer's investment profile.

The Care Obligation is an area where documentation is paramount to ensure compliance and mitigate risk, despite the Adopting Release stating that the Care Obligation does not require that broker-dealers document the basis for a recommendation.[18] Broker-dealers are well served by focusing on the following part of the Adopting Release, particularly for securities other than

[14] Reg BI Adopting Release at 33375-33376.

[15] *Id*. at 33376.

[16] *Id*.

[17] *See* SEC, *Staff Bulletin: Standards of Conduct for Broker Dealers and Investment Advisers Care Obligations*, Question 10 (Apr. 20, 2023).

[18] Reg BI Adopting Release at 33382.

equities: "broker-dealers may wish to document an evaluation of a recommendation and the basis for the particular recommendation in certain contexts, such as the recommendation of a complex product, or where a recommendation may seem inconsistent with a retail customer's investment objectives on its face [or when viewed in isolation]."[19] The SEC explained, for example, that recommending an investment that would be risky by itself may be in the retail customer's best interest if the investment was added as a hedging tool in a conservative portfolio.[20] The documentation discussion that is embedded in the Care Obligation section of the Adopting Release has resulted in a range of risk-based industry practices, with an ever-growing focus on documentation.[21]

Notably, the Care Obligation Staff Bulletin further clarified the importance of documentation and supervision. As stated in the latest Staff Bulletin, "[i]t is the staff's view that it may be difficult for a firm to assess periodically the adequacy and effectiveness of its policies and procedures or to demonstrate compliance with its obligations to retail investors without documenting the basis for such conclusions."[22] Nonetheless, broker-dealers have the obligation to assess the adequacy and effectiveness of policies and procedures and to demonstrate compliance with them.

(iii) Series of Recommended Transactions (or Quantitative) Prong

This component, which incorporated FINRA's "quantitative suitability" requirement, is designed to address practices like "churning," where a broker, whose compensation is based on transaction volume, recommends an excessive number of trades, which in isolation may be suitable, but in totality may result in a customer bearing unexpectedly high trading costs that negate the underlying economic returns from a given set of transactions. Reg BI's approach differs from FINRA's rule in that FINRA only required broker-dealers to satisfy quantitative suitability when a broker-dealer has control over a customer account. Reg BI does not include this "control" provision.

(c) Conflict of Interest Obligation

The Conflict of Interest Obligation requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to identify and at a minimum disclose, in accordance with the Disclosure Obligation, or eliminate conflicts of interest associated with recommendations made to retail customers, and to mitigate certain identified conflicts (if those conflicts were not otherwise eliminated).

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[19] *Id*. at 33378.

[20] *Id*.

[21] A continuing area of Reg BI concern remains the concept of reasonably available alternatives. The staff provided some limited examples in the Care Obligation Staff Bulletin, all rooted in documentation.

[22] SEC, *Staff Bulletin: Standards of Conduct for Broker Dealers and Investment Advisers Care Obligations* (Apr. 20, 2023).

(i) Identifying Conflicts of Interest

According to the SEC, reasonably designed policies and procedures to identify conflicts of interest generally should do the following:

- Define such conflicts in a manner that is relevant to a broker-dealer's business (i.e., conflicts of both the broker-dealer entity and the associated persons of the broker-dealer), and in a way that enables employees to understand and identify conflicts of interest;
- Establish a structure for identifying the types of conflicts that the broker-dealer (and associated persons of the broker-dealer) may face;
- Establish a structure to identify conflicts in the broker-dealer's business as it evolves;
- Provide for an ongoing (e.g., based on changes in the broker-dealer's business or organizational structure, changes in compensation incentive structures, and introduction of new products or services) and regular, periodic (e.g., annual) review for the identification of conflicts as-sociated with the broker-dealer's business; and
- Establish training procedures regarding the broker-dealer's conflicts of interest, including conflicts of natural persons who are associated persons of the broker-dealer, how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest.

(ii) Elimination and Mitigation

The Conflict of Interest Obligation requires broker-dealers to establish policies and procedures reasonably designed to identify and eliminate "any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time." Other than sales contests, conflicts of interest generally can be addressed through mitigation and disclosure.

The Reg BI Adopting Release does not prescribe how conflicts should be mitigated. However, it has stated that it would look to whether policies and procedures are "reasonably designed to reduce the incentive for the associated person to make a recommendation that places the associated person's or firm's interests ahead of the retail customer's interest."[23] The SEC provides the following examples of mitigation measures:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Minimizing compensation incentives for employees to favor one type of account over another; or to favor one type of product over another, proprietary or preferred provider

[23] Reg BI Adopting Release at 33391.

products, or comparable products sold on a principal basis, for example, by establishing differential compensation based on neutral factors;

- Eliminating compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers;
- Implementing supervisory procedures to monitor recommendations that are: near compensation thresholds; near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or involve the rollover or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA)[24] or from one product class to another;
- Adjusting compensation for associated persons who fail to adequately manage conflicts of interest; and
- Limiting the types of retail customer to whom a product, transaction or strategy may be recommended.

Firm-level financial incentives generally may be addressed through disclosure rather than mitigation. However, broker-dealers are required to identify and mitigate conflicts of interest that create an incentive for an associated person of the broker-dealer to place its interests or the interest of the firm ahead of the retail customer's interest. Additional granularity is provided in the Conflicts Staff Bulletin.[25]

(iii) Ownership of the Conflict of Interest Obligation

Unlike the Disclosure and Care Obligations, which apply both to broker-dealers and their associated persons, the Conflict of Interest Obligation (and the Compliance Obligation) applies solely to the broker-dealer firm. However, the firm is required to consider conflicts between: (i) the broker-dealer firm and the retail customer; (ii) the associated persons and the retail customer; and (iii) the broker-dealer firm and its associated persons.

(d) Compliance Obligation

The Compliance Obligation requires that broker-dealers establish, maintain and enforce written policies and procedures to achieve compliance with Reg BI as a whole. This obligation was included in the final rule but was not part of the initial rule proposal in 2018.

The policies and procedures must address compliance with the Disclosure and Care Obligations, in addition to the Conflict Obligation. Reg BI does not mandate specific requirements to fulfill the Compliance Obligation; rather it provides flexibility to allow broker-dealers to establish

[24] Note that PTE 2020-02 takes into account Reg BI within its Impartial Conduct Standard component.

[25] *See* SEC, *Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest*, Questions 6-10 (Aug. 3, 2022).

compliance policies and procedures that accommodate a broad range of business models. The guidance for Reg BI allowed that broker-dealers could satisfy the obligation by adjusting and/or building upon current systems of supervision and compliance, as opposed to creating entirely new systems.

From an enforcement perspective, this component of Reg BI allows the SEC to bring Reg BI charges against broker-dealers for policies and procedures violations in the absence of an underlying Reg BI violation. Note however, that when that occurs, the SEC will also need to account for Section 15(b)(4)(e) of the Exchange Act, which creates a possible liability for failure to supervise by authorizing the Commission to impose a sanction on an associated person who "has failed reasonably to supervise, with a view to preventing violations of . . . [federal securities] statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision." Note the related safe harbor, under which no person can be liable for failure to supervise if: (1) there have been established procedures and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person; and (2) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.[26] In the context of an enforcement action, the safe harbor will add an obligation for the regulator to demonstrate causation.

Note also that FINRA Rule 3110 requires member firms to "establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."

2. Reg BI Examination Priorities and Early Enforcement Outcomes

(a) 2024 Examination Priorities

(i) SEC Priorities

On October 16, 2023, the Division of Examinations ("Examinations") issued its 2024 examination priorities which reflect a continued focus on Reg BI, Form CRS and investment adviser fiduciary standards.[27] Broker-dealers and investment advisers have been put on notice that Examinations will place an increased focus on the care obligation, including consideration of reasonably available alternatives, consideration of all costs associated with a recommendation, and approach to recommendations of account types, rollovers, sweep programs, and high-cost, complex, illiquid, and proprietary products. Examinations is also focusing on the conflicts obligation, including processes for identifying and disclosing conflicts and appropriately mitigating financial professional compensation (including overall structure and supervision). As in prior years, Examinations will additionally pay close attention to the content and delivery of

[26] Section 15(b)(4)(e) of the Exchange Act.

[27] SEC, *Division of Examinations 2024 Examination Priorities* (Oct. 16, 2023).

required disclosures, as well as adopting reasonably designed policies and procedures, including supervision, systems for surveillance and training.

(ii) FINRA Priorities

FINRA also includes Reg BI as part of its Annual Regulatory Oversight Report. In the most recent 2024 iteration of the report,[28] FINRA noted that it had examined broker-dealers regarding implementation of Reg BI obligations throughout 2021-2023. The FINRA 2024 Annual Regulatory Oversight Report noted in its Reg BI section certain additional considerations and questions for firms to implement within their Reg BI implementation process. Notably, FINRA highlighted compensation practices and reasonably available alternatives.

(b) Recent Reg BI Enforcement Actions: SEC and FINRA

(i) SEC Enforcement Actions

TIAA-CREF Individual & Institutional Services LLC, Release No. 34-99549, Release No. IA-6559, February 16, 2024

According to the SEC order, the TIAA IRA allowed retail customers to invest in both a pre-selected "core menu" of affiliated investments, including affiliated mutual funds, and, through the TIAA IRA's optional "brokerage window," a broader array of securities, including a variety of mutual funds, ETFs, stocks and bonds. During the relevant period, the order states, "the brokerage window included the lowest-cost share classes of certain affiliated mutual funds offered in the core menu, but with the investment minimums waived." More than 94% of TIAA IRA customers invested only through the core menu, and as a result, paid more than $900,000 total in expenses that could have been avoided by purchasing substantially equivalent funds through the brokerage window. TC Services violated Reg BI by, among other things, failing to disclose both that substantially equivalent, lower-cost share classes of affiliated funds were available in the brokerage window and the conflicts that created. We note that this is an example of the SEC staff drawing from its various share class share disclosure related case theories and applying them within a Reg BI context.

Sanctions: Censure; $1,250,000 penalty; $936,714 disgorgement; $103,424.91 prejudgment interest.

Laidlaw and Company (UK) LTD., Release No. 34-98983, November 20, 2023

According to the SEC order, Laidlaw violated Exchange Act Rule 15l-1(a)(2)(ii), Reg BI's Care Obligation, when two of its registered representatives made a series of recommendations to six

[28] FINRA, *Regulatory Obligations and Related Considerations*, as part of *2024 FINRA Annual Regulatory Oversight Report* (Jan. 2024), https://www.finra.org/rules-guidance/guidance/reports/2024-finra-annual-regulatory-oversight-report/reg-bi-form-crs.

retail customers without a reasonable basis to believe that the series of recommended transactions were not excessive when taken together in light of the retail customer's investment profile, and because the series of recommended transactions placed the financial interest of the firm ahead of the interest of the retail customers (the "quantitative prong" of the Care Obligation) in Exchange Act Rule 15l-1(a)(2)(ii)(C). Laidlaw also violated Exchange Act Rule 15l1(a)(2)(iv), the Reg BI Compliance Obligation, by failing to establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with the quantitative prong of Reg BI's Care Obligation. As a result of Laidlaw's violations of these Reg BI's component obligations, it also violated Exchange Act Rule 15l-1(a)(1), the Reg BI General Obligation, which requires compliance with Reg BI's four component requirements, including the Care and Compliance Obligations.

Sanctions: Censure; $223,328 fine; $547,712.36 disgorgement; $51,844.22 prejudgment interest.

CitiGroup Global Markets, Inc. and Citi International Financial Services, LLC, now known as Insigneo International Financial Services, LLC, Release No. 34-98609, Release No. IA-6440, September 28, 2023

According to the SEC order, Respondents did not comply with the Disclosure Obligation of Reg BI and the delivery requirement of Form CRS until April 2021, when Respondents mailed the disclosures and Form CRS to Existing Retail Customers. By that time, however, registered representatives of the firms had made approximately 31,600 securities recommendations to approximately 13,600 Existing Retail Customers, all without effecting delivery within the framework of the SEC's electronic delivery guidance for the required disclosures and Form CRS to nearly all those retail customers, in violation of Exchange Act Rule 15l-1(a)(1), as well as Section 17(a)(1) of the Exchange Act and Rule 17a-14(f)(3) thereunder.

Sanctions: Censure; $1,976,000 penalty.

Saloman Whitney LLC, Release No. 34-98619, September 28, 2023

According to the SEC order, during the relevant period, SW Financial, through several of its registered representatives, recommended a short-term, high-volume investment strategy to at least sixteen of its customers without a reasonable basis. As a result of this high volume of recommended transactions and their attendant commissions and fees, it would have been virtually impossible for these customers to achieve profits in their accounts. While these customers were left with aggregate losses in the Affected Accounts exceeding $1,000,000 for the relevant trading periods, SW Financial and these registered representatives collectively received over $660,000 in commissions and fees as a result of the excessive trading activities they recommended. SW Financial violated Sections 17(a)(1) and (3) of the Securities Act, Exchange Act Section 10(b) and Rules 10b-5(a) and (c) during the Relevant Period, and the Care Obligation of Regulation Best Interest (Exchange Act Rule 15l-1) from June 30, 2020, the compliance date for Reg BI, through June 2022. SW Financial also violated Reg BI's Compliance Obligation by failing

to establish, maintain and enforce policies and procedures reasonably designed to achieve compliance with Reg BI's Care Obligation concerning excessive trading during the Reg BI Period.

Sanctions: $216,896 disgorgement; $19,277 prejudgment interest.

An additional Reg BI SEC matter, *Western International*, has a pending settlement.[29]

(ii) FINRA Enforcement Actions (Acceptance, Waiver and Consent Orders)

Murray Securities, Inc., FINRA File No. 2021069350301, April 8, 2024

According to the Letter of Acceptance, Waiver and Consent ("AWC") for this matter, Murray Securities did not establish relevant procedures or policies related to Reg BI until over a year after the deadline. The policies that were implemented were vague and insufficient, lacking guidance on how to deal with conflicts of interest and ensuring the best interest of the customers during investment recommendations. The policies also did not include certain steps to prevent financial or other interests of stockbrokers from overriding those of their customers. Moreover, the firm's written supervision procedures lacked clear guidelines on the necessary supervisory actions, including how often to conduct reviews, the documentation of these reviews, and the use of automated systems or exception reports for oversight. FINRA found Murray Securities violated FINRA Rules 2010 and 3110 and Rule 15l-1 of the Securities Exchange Act of 1934.

Sanctions: Censure; $35,000.00 fine; and required to issue a certification within 60 days that verifies their compliance with Reg BI, along with accompanying exhibits to prove compliance.

Haywood Securities (USA) Inc., FINRA File No. 2019061852801, November 13, 2023

According to the AWC for this matter, from September 2014 through the present, Haywood USA recommended 134 sales totaling almost $11 million of 53 different private placements to U.S. customers without conducting reasonable due diligence of the issuers and the offerings. Therefore, from September 2014 until June 30, 2020, the firm failed to establish, maintain, and enforce a supervisory system, reasonably designed to achieve compliance with FINRA Rule 2111, in violation of FINRA Rules 3110 and 2010 and NASO Rule 3010. From June 30, 2020, to the present, the firm failed to establish, maintain, and enforce a supervisory system reasonably designed to achieve compliance with Reg BI, in violation of FINRA Rules 3110 and 2010. In addition, from September 2014 to February 2023, Haywood USA failed to file offering documents with FINRA in connection with 236 Canadian private placement offerings in violation of FINRA Rules 5123 and 2010.

[29] Joint Status Report, *SEC v. Western International Securities, Inc., et al.,* No. 2:22-cv-04119-WLH-JC (C.D. Cal. Mar. 20, 2024). Note, however, the parties in the matter have requested an additional sixty days to report to the Court or file a motion of entry of judgment. *See* Second Joint Status Report, *SEC v. Western International Securities, Inc., et al.,* No. 2:22-cv-04119-WLH-JC (C.D. Cal. May 6, 2024).

Sanctions: Censure; $175,000 fine; required to issue a certification within 60 days that verifies their compliance with Reg BI, along with accompanying exhibits to prove compliance.

Network 1 Financial Securities, Inc., FINRA File No. 2021070851501, August 31, 2023

According to the AWC for this matter, from January 2016 through March 2022, Network 1 did not establish, maintain, and enforce a supervisory system, including written supervisory procedures (WSPs) reasonably designed to achieve compliance with the suitability requirements of FINRA Rule 2111 and the Care Obligation of Rule 15l (Reg BI) as they pertain to excessive trading in violation of FINRA Rules 3110 and 2010. As of June 30, 2020, Network 1 also violated Reg BI's Compliance Obligation by not establishing, maintaining, and enforcing WSPs reasonably designed to achieve compliance with Reg BI. Additionally, from July 2017 through March 2022, Molinaro, Network 1's chief compliance officer, violated FINRA Rules 3110 and 2010 by not establishing, maintaining, and enforcing a supervisory system, including WSPs, reasonably designed to achieve compliance with FINRA Rule 2111 and, as of June 30, 2020, Reg BI, as they pertain to excessive trading.

Sanctions (Network 1): Censure; $200,000 fine; $533,587 plus interest restitution; required to issue a certification within 90 days that verifies their compliance with Reg BI, along with accompanying exhibits to prove compliance. *Sanctions (Network 1):* three-month suspension from association with any FINRA member in all principal capacities; $5,000 fine.

Monmouth Capital Management, LLC, FINRA File No. 2022076459303, July 6, 2023

According to the AWC for this matter, from August 1, 2020, through February 28, 2023, Monmouth, acting through six registered representatives, excessively traded 110 customer accounts, of which 42 were also churned, causing the customers to incur $3,953,492 in total trading costs. The trading in the 110 customer accounts resulted in annualized cost-to-equity ratios ranging from 21.75% to 128.5%, and annualized turnover rates ranging from 6.05 to 35.24, and each of the accounts suffered substantial losses. As a result, Monmouth willfully violated the Care Obligation of Reg BI, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5, and also violated FINRA Rules 2020 and 2010.

From August 1, 2020, through the present, Monmouth also failed to establish, maintain, and enforce a supervisory system and written supervisory procedures (WSPs) reasonably designed to achieve compliance with the Exchange Act and FINRA rules relating to excessive trading and churning. In July 2020, Monmouth represented to FINRA that it had improved its supervisory system, including revising its WSPs to provide specific actions to take to monitor for, and address, red flags of excessive trading and churning. Monmouth's representations to FINRA were inaccurate. Until at least December 2022, the firm's supervisors failed to take any of the promised remedial steps, including reviewing monthly active account exception reports and sending active account letters to customers. As a result, Monmouth willfully violated Reg BI's Compliance Obligation and violated FINRA Rules 3110 and 2010. Additionally, between November 9, 2020, and February 28, 2023, Monmouth provided false and misleading disclosures on its Form CRS

concerning the scope of its account monitoring services and the nature of certain trading costs it charged to customers. These misrepresentations included a statement that Monmouth would monitor customer accounts utilizing daily exception reports, but the firm did not in fact utilize these reports. As a result, Monmouth willfully violated Section 17(a)(1) of the Exchange Act and Exchange Act Rule 17a-14 and also violated FINRA Rule 2010. During this same period, Monmouth also failed to have a reasonable supervisory system, including WSPs, to ensure that its customer disclosures on Form CRS were not false or misleading. As a result, Monmouth violated FINRA Rules 3110 and 2010.

Sanctions: Expulsion from FINRA Membership.

SW Financial, FINRA File No. 2020065599101, May 11, 2023

According to the AWC for this matter, between January 2018 and December 2021, SW Financial made material misrepresentations and omissions to investors in connection with the sale of private placement offerings of pre-initial public offering (pre-IPO) funds (the Offerings). SW Financial misrepresented to investors that it would receive only a ten percent sales commission from its sale of the Offerings when, in fact, SW Financial had entered into an agreement with the issuer to receive an additional five percent in selling compensation as well as half of any carried interest. SW Financial never disclosed this agreement or the additional compensation it would receive to investors. SW Financial also made misrepresentations to FINRA about the amount of compensation it would receive in connection with the Offerings. As a result, SW Financial violated FINRA Rule 2010, both independently and by virtue of violating Sections 17(a)(2) and (3) of the Securities Act of 1933. SW Financial, for its misconduct occurring on or after June 30, 2020, also willfully violated the Disclosure Obligation of Reg BI, set forth at Rule 15l-1(a)(2)(i)(B) under the Exchange Act and violated FINRA Rule 2010. Moreover, prior to recommending and selling the Offerings, SW Financial failed to confirm that the issuer of the Offerings had possession of or access to the pre-IPO shares identified in the offering documents or that the issuer's markups were reasonable and not excessive. SW Financial therefore lacked a reasonable basis to believe that the Offerings were suitable for, or in the best interests of, at least some customers. As a result, SW Financial violated FINRA Rules 2111 and 2010, and willfully violated the Care Obligation of Reg BI in Exchange Act Rule 15l-1(a)(2)(ii)(A).

Furthermore, according to the AWC for this matter, between January 2016 and May 2019, SW Financial, acting through two former registered representatives, churned nine customer accounts, causing the customers to incur more than $350,000 in total trading costs and realized losses of more than $465,000. As a result, SW Financial willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and also violated FINRA Rules 2020, 2111, and 2010. In connection with both types of misconduct, SW Financial also violated FINRA Rule 3110. Specifically, from January 2018 through December 2021, SW Financial failed to establish, maintain, and enforce a reasonably designed supervisory system and procedures with respect to the firm's sale of private placement offerings. And, from January 2016 through November 2019, SW Financial failed to establish, maintain, and enforce a supervisory system and procedures

reasonably designed to achieve compliance with the Exchange Act and FINRA rules relating to excessive trading and churning. Therefore, SW Financial violated FINRA Rules 3110 and 2010.

Sanctions: Expulsion from FINRA Membership.

3. Advisers Act Fiduciary Standard

Simultaneous with its adoption of Reg BI, the SEC issued interpretive guidance regarding the standard of conduct for investment advisers.[30] The SEC retained two separate standards of conduct for broker-dealers and investment advisers in recognition of the differences in the types of relationships that broker-dealers and investment advisers have with their clients and different models for providing advice. Investment advisers' fiduciary duty under the Advisers Act is based on common law principles and includes a duty of loyalty and a duty of care. With respect to disclosure, investment advisers are already required, under federal securities laws, rules and regulations, to make ongoing disclosures, particularly regarding fees and conflicts, to retail investors via Form ADV filings and deliveries. Also, unlike broker-dealers, investment advisers already have a disclosure obligation under the fiduciary standard's duty of loyalty.

For additional information and analysis on the impact of the Adviser Interpretation, please refer to *Fiduciary Obligations for Identifying, Managing, and Disclosing Conflicts of Interest,*[31] and *Ethics for Advisers: Compliance with Fiduciary Standards Spotlight on Code of Ethics Requirements*.[32]

4. Beyond the SEC: State Securities Regulators and DOL

(a) NASAA Model Rule Proposal

In September 2023, the North American Securities Administrators Association ("NASAA") published a Model Rule proposal intended to update NASAA's existing Model Rule on "dishonest or unethical practices" pertaining to broker-dealers and agents.[33] The proposed Model Rule broadly calls for the incorporation of the principles encompassed in Reg BI. However, the proposed Model Rule contains "subparts" that are presented as a "menu of provisions" to be used to "define, clarify or emphasize the obligations and components of Reg BI that matter most to each jurisdiction." In addition to this proposal potentially contributing to the development of disparate standards, there are significant industry concerns that these subparts call for different

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[30] *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, 84 FR 33669 (July 12, 2019).

[31] A. Valerie Mirko & Margaret Mudd, *Fiduciary Obligations for Identifying, Managing, and Disclosing Conflicts of Interest* (Sept. 1, 2023).

[32] A. Valerie Mirko et al., *Ethics for Advisers: Compliance with Fiduciary Standards Spotlight on Code of Ethics Requirements* (Mar. 6, 2024).

[33] NASAA, Proposed Revisions to Model Rule on Dishonest or Unethical Business Practices of Broker-Dealers and Agents (Sept. 5, 2023), available at https://www.nasaa.org/wp-content/uploads/2023/09/Request-for-Public-Comment-on-BD-Best-Interest-Model-Rule.pdf.

standards than those under Reg BI. A key example is how the Model Rule defines "recommendation" relative to the SEC's discussion in the adoption of Reg BI and other well-established FINRA/SEC guidance.[34] The comment period for this proposal closed in early December 2023 and comments remain under consideration.

(b) Massachusetts Fiduciary Rule

In February 2020, the Massachusetts Securities Division of the Secretary of State ("MSD") adopted final regulations governing the standard of conduct applicable to broker-dealers and their agents. The regulations apply a fiduciary duty standard of conduct to broker-dealers and agents and went into effect in March 2020. Enforcement of the regulations began September 1, 2020. The Massachusetts rule requires broker-dealers and their agents to act as fiduciaries: when providing investment advice or recommending to a customer an investment strategy, the opening of, or transfer of assets to, any type of account, or the purchase, sale, or exchange of any security.

The most significant difference between the Massachusetts rule and Reg BI is the language regarding how broker-dealers are required to address financial conflicts of interest. The duty of loyalty under the Massachusetts regulation requires, in part, that broker-dealers and their agents "[m]ake recommendations and provide investment advice *without regard* to the financial or any other interest of any party other than the customer."[35] The Massachusetts rule's Adopting Release attempted to clarify that, when viewed together with the other elements of the duty of loyalty under the rule, the "without regard to" language does not create an absolute requirement to provide conflict-free advice. In contrast, the SEC considered using the "without regard to" language in Reg BI, but ultimately decided to adopt phrasing requiring that broker-dealers do not place their financial or other interest ahead of the interest of the retail customer. The SEC reasoned that the "'without placing the financial or other interest . . . ahead of the interest of the retail customer' phrasing recognizes that while a broker-dealer will inevitably have some financial interest in a recommendation—the nature and magnitude of which will vary—the broker-dealer's interests cannot be placed ahead of the retail customer's interest."[36]

After being struck down by the lower court, the Massachusetts Supreme Judicial Court upheld the fiduciary rule on August 25, 2023.[37] The case was settled on January 18, 2024.[38] There is currently an ongoing Massachusetts Securities Division sweep.

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[34] For a more detailed analysis comparing Reg BI and NASAA's Model Rule, *see* Valerie Mirko, *Summary & Comparison Chart: NASAA Proposed Broker-Dealer Model Rule and SEC Regulation Best Interest* (Dec. 1, 2023); *see also* Kevin M. Carroll, *SIFMA Comment Letter: Proposed Revisions to NASAA Broker-Dealer Model Rule* (Dec. 1, 2023).

[35] 950 CMR 12.207(2)(b)(3) (emphasis added).

[36] Reg BI Adopting Release at 33332.

[37] Robinhood Financial LLC v. Secretary of Commonwealth, 214 N.E.3d 1058 (2023).

[38] *See* Hannah Miao, *Robinhood to Pay $7.5 Million to Settle Massachusetts 'Gamification' Case*, WALL STREET JOURNAL (Jan. 18, 2024), https://www.wsj.com/livecoverage/stock-market-today-dow-jones-earnings-01-18-

(c) DOL Fiduciary Rule

On April 23, 2024, the U.S. Department of Labor ("DOL") released a final rule, titled the "Retirement Security Rule" (the "Final Rule"),[39] updating the longstanding meaning of what constitutes "investment advice" under the definition of "fiduciary" under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The DOL believes that the retirement landscape has changed since ERISA was enacted, and as such, retirement investors who mainly save through defined contribution plans and IRAs, rather than traditional defined benefit plans, are not receiving adequate protections when investment-related decisions are being made in relation to their plans and savings. Thus, the DOL believes that any such advice should be made under the protections provided by the ERISA fiduciary classification. The Final Rule is already subject to litigation. Below is a description of the Final Rule, though we urge affected firms to consult ERISA counsel as Final Rule implementation begins or continues as the litigation could have a material impact on whether to implement the Final Rule or not.

The Final Rule simplifies the determination of who is an ERISA investment advice fiduciary by stating that only two conditions need to be met:

(1) if the person makes a "*recommendation*" of any securities transaction or other investment transaction or any investment strategy to a "*retirement investor*" for a fee or other compensation (direct or indirect), and

(2) such recommendation is made either directly or indirectly (e.g., through or together with any affiliate) to investors on a regular basis as part of their business, and the recommendation is made under circumstances that would indicate to a reasonable investor in like circumstances that the recommendation:

  (i) is based on review of the retirement investor's particular needs or individual circumstances,

  (ii) reflects the application of professional or expert judgment to the retirement investor's particular needs or individual circumstances, and

  (iii) may be relied on by the retirement investor as intended to advance the retirement investor's best interest; or the person represents or acknowledges that they are acting as a fiduciary under ERISA with respect to the recommendation.

Under the Final Rule, a "*retirement investor*" is defined as a plan, plan fiduciary, plan participant or beneficiary, IRA, IRA owner or beneficiary, or IRA fiduciary. The term "*recommendation*" has been defined to mean:

2024/card/robinhood-to-pay-7-5-million-to-settle-massachusetts-gamification-case-L38We94jHxZWKR0NqWcz.

[39] Retirement Security Rule: Definition of an Investment Advice Fiduciary, 89 Fed. Reg. 32,122 (Apr. 25, 2024) (to be codified at 29 C.F.R. § 2510.3-21).

(1) the advisability of acquiring, holding, disposing of, or exchanging securities or other investment property, investment strategy, or how securities or other investment property should be invested following a rollover, transfer, or distribution from a plan or IRA;

(2) the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements, or voting of proxies appurtenant to securities; or

(3) rollovers, transfers, or distributions of assets from a plan or IRA, including recommendations as to whether to engage in the transaction, the amount, the form and the destination of such a rollover, transfer or distribution.

The Final Rule also clarifies that under the definition of "retirement investor," individuals who render investment advice as an ERISA fiduciary to a plan or IRA are not themselves retirement investors and therefore communications with such investment advice fiduciaries would not result in a fiduciary relationship. Furthermore, sales pitches and investment education are not going to give rise to a fiduciary relationship unless the information is individualized to the particular needs of the retirement investor.

(i) Amendments to Prohibited Transaction Exemptions 2020-02 and 84-24

Prohibited Transaction Exemptions 2020-02 ("PTE 2020-02") generally permits ERISA fiduciaries to accept reasonable compensation for providing investment advice provided that the conditions contained in the exemption are followed. The DOL, in an attempt to streamline investment advice safeguards, has amended the investment advice portions of 84-24 ("PTE 84-24"), which provides relief to ERISA fiduciaries when receiving compensation related to certain insurance and mutual fund transactions with a plan, to closely follow the requirements contained in PTE 2020-02 and has eliminated from the ability of other prohibited transaction exemptions from exempting investment advice compensation going forward.[40] Broker-dealers, investment advisers and independent insurance agents will need to familiarize themselves with the changes to these exemptions when providing investment advice to retirement investors in the future.

When finalizing the amendments to PTE 2020-02, the DOL did clarify some points that were deemed to be very important to firms subject to the Final Rule:

[40] The DOL has officially eliminated from Prohibited Transaction Exemptions: 75-1 "Securities Transactions Involving Broker-Dealers, Reporting Dealers and Banks," 77-4 "Purchase of Shares of Open-End Investment Companies," 80-83 "Use of Proceeds from Sale of Securities to Reduce or Retire Indebtedness," 83-1 "Mortgage Pool Investment Trusts" and 86-128 "Executing Securities Transactions and Recapture of Commissions," the portion of those exemptions that allowed fiduciaries to receive reasonable compensation as of September 24, 2024.

- The DOL expanded relief to all principal and agency transactions where investment advice is provided by an investment advice fiduciary.
- Pooled plan advisors and robo-advisers may rely on PTE 2020-02 as covered providers.
- Financial institutions and investment professionals need to provide a written acknowledgement of fiduciary status and make certain disclosures regarding fees, scope of services and conflicts of interest.
- A financial institution must establish and maintain written policies and procedures to comply with the Impartial Conduct Standards contained in the exemption. The policies are subject to inspection by the DOL and must be reviewed annually by the financial institution to ensure compliance with the exemption. There is also a six-year retention of records requirement related to compliance with the exemption.
- Entities that are convicted of a relevant crime or final judgement will disqualify the entity's entire control group from using the exemption for ten years.

The changes made to PTE 84-24 could impact the insurance industry as only independent agents selling non-securities annuities or other insurance products not regulated by the SEC can rely on this exemption going forward and the more burdensome requirements of PTE 2020-02 will need to be complied with for investment advice transactions by the rest of the insurance industry. The final amendments to this exemption's investment advice conditions closely align with the provisions in PTE 2020-02.

Highlights from the DOL amendments are:

- An insurance company selling its product through independent agents is not a fiduciary but is required to exercise supervisory authority over any independent agent's recommendation of the insurance company's own products. To do this, the insurance company must (i) maintain and enforce written policies to review recommendations being made by the independent agent, and (ii) conduct an annual review of the independent agent to ensure no violations of the exemption's conditions.
- The exemption does not apply to variable annuities or types of securities. PTE 2020-02 will apply in those situations.
- Expanding the disqualification provisions to conform with PTE 2020-02.

Both PTE 2020-02 and PTE 84-24 are subject to a one-year phase-in period, beginning on September 24, 2024. This means that investment professionals that comply with the Impartial Conduct Standards and the ERISA fiduciary acknowledgement requirement contained in PTE 2020-02 will be permitted to accept reasonable compensation until September 24, 2025.