

# Increased Enforcement action of Reg BI and its impact on wealth manager's Reg Tech

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The Investor Protection Framework has been a key focus area for regulators for a long time. While the Securities and Exchange Commission's (SEC) fiduciary rule governs the financial advisors, the brokers have been regulated by the Financial Industry Regulatory Authority (FINRA) Rule 2111 (Suitability). The Department of Labor (DOL) fiduciary passed under Obama administration tried to create a common framework for the governance for brokers and advisors, but the rule was vacated following strong opposition from brokers and industry groups.

In June 2019, the SEC passed the Regulation Best Interest (REG BI), which established that broker-dealers and financial advisors need to work in the best interest of the consumer and eliminate conditions that further a firm's interest over a client's interest.

The rule came into effect in June 2020 and initially the consumer advocates were quite apprehensive that the regulation was too weak and would not advance consumer protection in a significant way. However, the SEC has started enforcing compliance of REG BI rules with gusto and over the last one year has already fined 42 firms ranging between 100 million to 900 million in AUM for inadequate compliance to Form CRS (a key component of Reg BI). The SEC has also indicated the number and penalty amount are only going to increase if the wealth management firms do not start following the regulation in true spirit. A recently published FINRA exam report highlighted that some firms were not even meeting their basic obligations for compliance with Reg BI and Form CRS. The report highlighted deficiencies in written supervisory procedures, inadequate staff training, failure to comply with care and conflicts of interest obligation among various other gaps. This white paper will try to assess how the regulations impact the industry, brokers, and the various systems and applications.

## Reg BI – A Quick Summary

Before we get into the impact of the new regulation, let us summarize its key tenets.

The regulation can be divided into four main parts. We will focus on the first two parts, as they form the crux of the overall regulation and will drive maximum operational impact. The other two parts would be relevant to incidental clauses for brokers and lean towards interpretation or reaffirmation.

- 1) REG BI** - In a nutshell, the regulation directs the brokers to act in the best interest of their clients while providing investment or account recommendations, and always place the client's interest before the firm's or broker's interests.

### **These Obligations are:**

- A) Disclosure Obligation** - All material facts about the broker-dealers, including the services provided, fees charged, etc.
  - B) Care Obligation** - This is quite similar to FINRA's suitability standard and directs the advisors to exercise diligence and care when recommending any investment to the client and consider the client's investment profile, the associated risks, and the costs involved with such an investment.
  - C) Conflicts-of-interest Obligation** - This obligation mandates broker-dealers to create policies and procedures that disclose or eliminate any conflicts of interest, and eliminate limitations or conditions which encourage brokers to place the firm's interest ahead of the client's interest.
  - D) Compliance Obligation** - Establish policies to achieve compliance with Reg BI. The regulation emphasizes that the brokers should always act in the best interest of the client, and the regulation cannot be satisfied only by disclosures.
- 2) Form CRS (Customer Relationship Summary)** - In addition, the rule mandates that brokers, as well as financial advisors, should provide a customer relationship summary form (Form CRS) to the clients, which will summarize the nature of the client's relationship with the broker or advisor and allow them to compare the broker model with the advisor model.

### **The format of the Form includes:**

- Introduction to the firm
- Details of the services offered
- Types of fees charged and the code of conduct
- Disciplinary history of the firm and its advisors, including details disclosed in Forms ADV, U4, etc.
- Other information, including details of how the clients can request and obtain a copy of Form CRS

**“ While the term best interest has not been clearly defined, the SEC does provide a set of subordinate obligations, which in combination can be read as best interest duties/obligations of a broker. ”**

**“ While Reg BI has been defined only for Brokers, Form CRS needs to be provided/ filed by both Brokers as well as Investment Advisors ”**

In addition to providing the form to existing as well as new clients, the form also needs to be electronically filed on WebCRD by brokers and on IARD by advisors. For financial advisors, although most of the requirements of Form CRS are covered in Form ADV's Part 2A and 2B, the form will still be added to the Form ADV and become a third part of the same. Dually registered reps will have to file the form with both WebCRD and IARD.

# Impact on Broker-Dealer/ RIA Systems

The regulations leave room for interpretation. The compliance teams and industry consultants at various broker-dealers have to come up with an impact assessment on how the current operations and compliance processes get impacted. The wealth managers then need to establish procedures, best practices to ensure adherence to the regulation.

Below is a high-level summary of how the various broker-dealer systems are impacted by the best interest regulation.

- 1) Trade Review Systems** - FINRA has remarked that they may tweak or totally remove Rule 2111 since the duty of care under REG BI closely mirrors and enhances the suitability rule. Therefore, the trade review systems have to account for changes in the suitability rule, wherein, additional parameters such as the cost of the investment option also have to be evaluated while judging whether the advice was suitable for the client or not. The current suitability standard is applicable to specific securities recommendations. In addition, the care obligation will also apply to the rollover / account opening recommendations, and the trade review systems need provision for including these additional recommendation types.
  
- 2) Other Compliance Systems** - The regulation impacts multiple other compliance systems. The systems which produce the Form ADV need to be modified to accommodate the amendments related to Form CRS. For the brokers, Form CRS needs to be produced by including data about fees, policies, disclosures, and disciplinary history, etc. which may need to be sourced from multiple applications. Compliance policies need to be amended to follow the principles laid out in the best interest regulation and therefore, may impact a firm's learning management systems. Written supervisory procedures need to be redrafted to ensure compliance with Reg BI & Form CRS and the WSPs need to establish clear controls and responsibilities. FINRA CEO, Robert Cook also indicated that FINRA will be re-evaluating some of its rules that were enacted prior to Reg BI. This may bring in further changes to the compliance and supervision systems.

- 3) **Digital Advice Platforms** - Reg BI is likely to drive wider adoption of the digital advice platforms for delivering recommendations. Brokers should keep a record of their recommendations and what kind of due diligence was followed while determining whether the recommendations were in the best interest of the client. Such analysis and record-keeping can be more easily done on an electronic platform.
- 4) **Account Opening Systems** - Form CRS should be integrated with account opening platforms and the workflows should present the Form CRS to the client once the accounts are opened. In addition, if the account opening systems are integrated with WebCRD and IARD, then these systems need to push Form CRS for electronic filing.
- 5) **Document Management/mail Archival System** - The regulation requires that Form CRS be stored for future auditing purposes. Accordingly, the document management system will have to provision for keeping a record of the date and content of all Form CRSs shared with the customers and any subsequent amendments to it. If the Form CRS is electronically delivered, then the email archival system needs to be configured to maintain a record of such correspondences.
- 6) **Company Websites** - Form CRS needs to be prominently posted on the wealth manager's website in a way that the clients can easily find it.

As mentioned at the start of the white paper, SEC has indicated a clear intent to ensure compliance with Reg BI in full letter and spirit. The FINRA exam report has also brought to fore the stark failures of the various wealth management firms vis-a-vis ensuring adequate procedures and full and fair disclosures regarding investment recommendations, conflicts of interest and material fees.

In light of increased regulatory focus, therefore, it behooves all compliance officers to conduct their own internal assessments and audits to ensure full compliance with the rule at the earliest.

**“ 2022 is likely to bring even more regulatory action and increased fines in case of non-compliance with REG BI provisions. Firms should take cue from FINRA's suggested best practices to ensure full compliance ”**

## Contact Information



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