

AI Insight & Bates Compliance
present

Understanding Regulation Best Interest

Webinar - 4 p.m.

February 27, 2020

Speakers

Bates Compliance



- ▶ **David Birnbaum** is a Managing Director of Bates Group and member of the Bates Compliance team, based in New York City. Prior to joining Bates Group, David was the principal legal executive and advisor to Merrill Lynch's U.S. and international wealth management and private banking businesses, and he led the Legal Team supporting executive, home office, and field-based management, and over 16,000 Financial Advisors. David and his team provided day-to-day tactical and strategic advice and support to all aspects of the business including: regulatory inquiries/investigations; responses to regulatory proposals; interpretation and compliance with laws and regulations; arbitration and litigation matters; recruitment and employment; internal investigations and discipline; dispute resolution; new products; marketing and sales; and operations and back office.
- ▶ **Linda Shirkey** is a Managing Director of the Bates Compliance team based in Houston, TX. As President and founder of The Advisor's Resource, Inc., she has provided compliance expertise to Registered Investment Advisers for over 20 years. A former institutional stockbroker covering money managers and major corporations, Ms. Shirkey was with Charles Schwab & Co., Inc., for ten years. Prior to this, Ms. Shirkey worked in banking and legal services in product development, marketing and corporate finance.
- ▶ **Bates Compliance**, the compliance division of Bates Group LLC, brings tailored compliance consulting solutions to financial services clients. Our compliance team includes senior compliance staff and former regulators who test policies, procedures, supervisory and compliance processes, recommending changes and best practices to enhance compliance and supervisory systems, and to remediate the results of regulatory and litigation findings.

Topics We Will Cover

1. Reg BI Background
2. New Obligations
3. Regulator Expectations
4. Impact on Products Sales
5. Conflicts, Compensation, Disclosure
6. Q & A
7. Reg BI Resources

Reg BI - Background

- ▶ On April 18, 2018, the Securities and Exchange Commission (“SEC”) proposed a three-part regulatory framework designed to provide clarity for retail customers of broker-dealers and investment advisers.
- ▶ June 5, 2019: The SEC votes 3-1 in favor of passing Regulation Best Interest (“Reg BI”) and Form CRS which impacts broker-dealers and registered investment advisers. Intent of the new rules is to help retail customers gain a greater level knowledge and understanding to help them choose:
 - ▶ Type of professional they choose to work with
 - ▶ Services they will receive
 - ▶ How they pay for services
- ▶ Reg BI expands the current suitability standard by requiring broker-dealers to put customers interest before their own. It is also more expansive than the suitability standard, as it applies to recommendations on rollovers, distributions, securities strategies and certain “hold” recommendations.
- ▶ As part of managing Reg BI, firms must address three key obligations of the rule:
 - ▶ Disclosures
 - ▶ Duty of Care
 - ▶ Conflicts of Interest

Conflicts of Interest

Compensation Conflicts

1. Profit sharing program
2. Proprietary products and reinsurance
3. Override payments
4. Subadvisor payments
5. Differently priced products
6. Incentive trips
7. Sponsored meetings
8. Software
9. 12b-1 fees
10. FMO/IMO bonus payments
11. Product promotions
12. Platform fees
13. Service fees
14. Vested compensation
15. Asset movement fees
16. Trade execution fees
17. Rollover/ transfer fees
18. Consulting and technical sales support
19. Broker dealer services
20. System fees
21. Web based administration, contract management, and commission tracking
22. Diversification of business investments
23. Marketing and administrative support
24. Compensation from carriers based on sales
25. Interest on non-qualified 401k products
26. Investment income
27. Carrier reimbursement

Structural Conflicts

1. Ownership

Relationship/Personnel Conflicts

1. Relationships with carriers
2. Product platform
3. Code of conduct
4. Advisory committees

Outside Business Activities Conflicts

1. Board positions
2. Board positions (affiliates)
3. Trustees
4. Issuers

Individual Conflicts

1. Gifts and entertainment
2. Political contributions
3. Policies for ethical conduct, insider trading, anti-bribery, anti-money laundering, and prohibited activities
4. Charitable giving
5. Personal securities transactions
6. Outside business activities
7. Board positions
8. Material non public information
9. Best execution
10. Trading ahead of customer orders

Reg BI Obligations

Disclosures

- Broker-dealers must disclose material facts about their relationship with the client and recommendations, including all fees, the broker-dealers scope of services and any limitations
- Disclose the nature of the relationship with the customer and the capacity which they are acting in
- Provided at or before the making of any recommendations, especially any conflicts of interest (specifically financial related conflicts)

Duty of Care

- Broker-dealers must exercise reasonable diligence, care and skill in making recommendations to a retail customer
- Broker-dealers must understand potential risks, rewards and costs associated with the recommendation
- Must consider the above in light of customer suitability information
- Requires the broker-dealer to consider cost as part of its decision

Conflicts of Interest

- Must establish, maintain and enforce policies and procedures specifically designed to ensure compliance with Reg BI, so that they:
- Mitigate conflicts that incentivize financial professionals to place their interests before their clients
- Prevent material limitations on offerings, such as limited product offerings or proprietary products only
- Eliminate sales contests, sales quotas, bonuses and non-cash comp that are tied to specific securities or types of securities within a limited period of time

Potential Challenges

Compensation

- Limits on compensation arrangements
- Reasonableness standard
- Proprietary products

Distribution

- Contract updates
- Some distribution channel changes

Increased Costs

- New compliance requirements
- Supervision and surveillance enhancements
- Technology assessments/enhancements

New Compliance Requirements

- Books and records requirements
- New Standard of care, disclosures and policies & procedures
- New Supervisory processes

Disclosures

- Updated disclosures
- Contracts with clients

Broker-Dealers face new challenges under Reg BI

Products, Tools and Services

- Firm may currently be offering “advice” related to the support around specific products as defined by the new Rule; e.g.,
 - Fixed Income
 - Annuities
 - Derivatives (including Options)
 - Rollovers

Marketing, Education and Training

- Education and marketing content through self-directed channels may fall under “advice”. Areas of consideration include, but are not limited to:
 - Customer dialogues
 - Online Tools and Platforms
 - Education Offerings
 - Marketing Collateral

Revenue Sharing / Fee Arrangements

- Revenue and fee-sharing arrangements with third parties may need to be disclosed and/ or modified; e.g.,
 - Mutual Fund Manufacturers
 - Annuities providers
 - IRA Rollover Partners
 - Proprietary products

Strategic Initiatives

- The new Rule may impact the design and timing of specific strategies and products
 - Growth and emphasis in bringing in new customers/AUM
 - New product arrangements and distribution
 - Use of proprietary products

Registered Person Compensation

- Sales grids will require review and potential updates
- Compensation programs to clients and third-parties may need to be reviewed
 - Solicitor arrangements
 - Manager of managers

Customer Experience

- Rule may alter current customer experience touchpoints. Examples include
 - Communications on Reg BI Rule and firm role
 - Additional disclosures on compensation, conflicts and product information
 - Contracts for ongoing monitoring for clients

Regulation Best Interest Operational Challenges

After the implementation of changes, companies will :

1. Maintain and test compliance in an uncertain litigation environment and further adapt policies and procedures;
2. Develop further product and compensation structure changes;
3. Design future sales practices and strategy
4. Home in on processes for product suitability and product shelf size
5. Develop technology solutions impacting data capture, products and best interest determinations
6. Establish an audit plan and program for future execution.

Maintain and Test Compliance and P&Ps

- Amend policies and procedures in response to litigation
- Reevaluate compliance testing, monitoring, surveillance and governance in response to litigation
- Assist in compliance testing for best interest review

Product and Compensation Structure Development

- Industry benchmarking
- Develop new products and amend existing non-compliant products
- Best interest product shelf rationalization
- Reevaluate compensation structure in response to litigation
- Marketing reviews

Future Sales Practices & Strategy

- Assess inherent risks and controls for improper sales practices
- Perform targeted data analytics to assess potential evidence of improper behavior and sales practices
- Effectively communicate expectations and train staff on expected sales practice risks and behavior
- Develop sales structure, goals, incentives that align with true drivers of profitability
- Identify realistic sales/performance targets for managers and staff

Conflicts of Interest

- Identify new previously undisclosed conflicts of interest (personal and business)
- Changes to new product development and onboarding processes
- Disclosure delivery processes for existing and new clients, as well as prospects

Technology Solutions Development

- Redesign technology infrastructure
- Improve systems and automated disclosure generation
- Review and test books and recordkeeping, data capture systems
- Review and test algorithms used for product shelf rationalization
- Third party vendor review

Audit Plan Development and Execution

- Identify risks and controls across the relevant businesses
- Develop a risk-based Audit Plan and customized testing program
- Perform walkthroughs of the relevant processes to understand key risks and controls
- Assess controls for design and operating effectiveness
- Report results and recommendations

Key Considerations

Risk/Governance

- Identification of implementation team, including Sales, Product Development, Compliance, Supervision, Operations, Technology and affiliates
- Conflicts Committee review and re-chartering
- Key business decisions will have to be made and monitored
- Limitations on the types of products that are offered
- Communications plan to clients, financial professionals, operations, technology, etc.

Business/Financial

- Compensation models will have to align to Best Interest, perhaps necessitating new compensation schemes
- Dual registrants will have to decide on a single standard of care or develop bifurcated processes
- Recommendations of rollovers vs. education only
- Vendor contracts, selling agreements and products may have to be reviewed and updated with providers
- Product shelved will have to be reviewed for conflicts and for compliance with Best Interest standards. Firms will have to implement product onboarding and review programs.
- Will financial professionals be allowed product discretion? Or will the firm prepare “packaged” product solutions

Operations/Technology

- Current gaps in data collection and data sources, including collection and tracking of fee information, contracts, amendments, and prospectuses
- New client and user interface tools (i.e., calculation engine) to produce appropriate and timely pre- and post- sale customer disclosures
- Books and records requirements, including documentation processes

Compliance/Supervision

- New standard of care, disclosures and policies & procedures
- New supervisory processes
- Additional compliance resources and surveillance
- Salesforce education and training
- Increased leveraging of technology for enhanced oversight and monitoring
- Enhanced supervision of expanded call center activities
- Commission payment/withholding for direct business not networked/supervised
- Enhanced or new processes may require a shift or further shift to a centralized supervision model

Regulator Expectations



- ▶ As we speak, regulators are conducting Reg BI readiness assessments
- ▶ Where you are in the process? Has your firm commenced Reg BI implementation?
- ▶ If not, why not?
- ▶ What do you need help with?
- ▶ SEC Priorities - The SEC is focusing specifically on Reg BI. Beyond the implementation date, OCIE's examinations will include "policies and procedures re: conflict disclosures, and for both broker dealers and RIAs, the content and delivery of Form CRS."
- ▶ FINRA Priorities - The regulator is currently reviewing Reg BI readiness. After the deadline, specifically, FINRA stated it will consider in its examinations whether: (i) adequate processes and procedures are in place to assess broker dealer best interest recommendations; (ii) the firm and associated persons are applying those standards; (iii) account monitoring adequately applies to both explicit and implicit hold recommendations; (iv) recommendations to retail customers are following "express new elements of care, skill and costs;" (v) customer recommendations take into consideration reasonably available alternatives; (vi) controls are in place to prevent excessive trading; (vii) adequate disclosures are provided for; (viii) conflicts of interest are adequately covered in policies and procedures; and (ix) filing and delivery of Form CRS is adequately addressed.
- ▶ Implementation Deadline June 30, 2020

State Developments

- ▶ States have proposed their own fiduciary standard for broker-dealers, agents, and investment advisers representatives
- ▶ State AGs from NY, CA, NM, OR and District of Columbia challenge Reg BI claiming it “undermines” consumer protections for retail investors
 - ▶ Massachusetts Securities Division - new rule, despite Governor and Legislature opposition
 - ▶ Other States: Maryland, New Jersey, Nevada

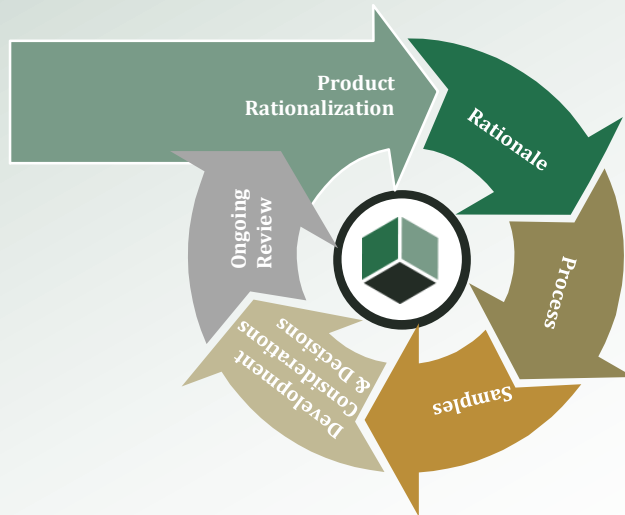
*****Despite legal challenges, firms must continue to implement and comply with Reg BI*****

Products

- ▶ Product Rationalization
 - ▶ Product Shelf & Approval Reviews
 - ▶ Supervision
 - ▶ Level compensation
 - ▶ Legacy products that may not meet current standards
- ▶ Conflicts
- ▶ Suitability
 - ▶ Asset Type
 - ▶ Specific Investments
- ▶ Fees

Product Rationalization

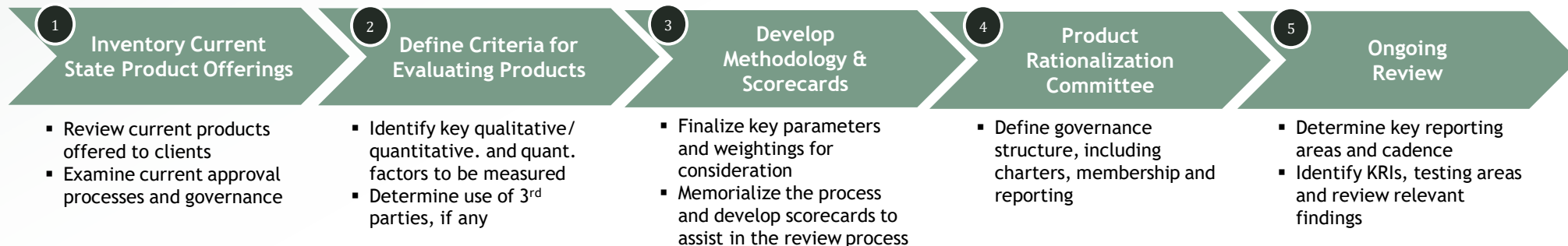
The financial services industry is becoming more client-focused. Clients are increasingly more educated around fees and conflicts of interest. Product rationalization is a critical step toward adapting to this industry-wide change.

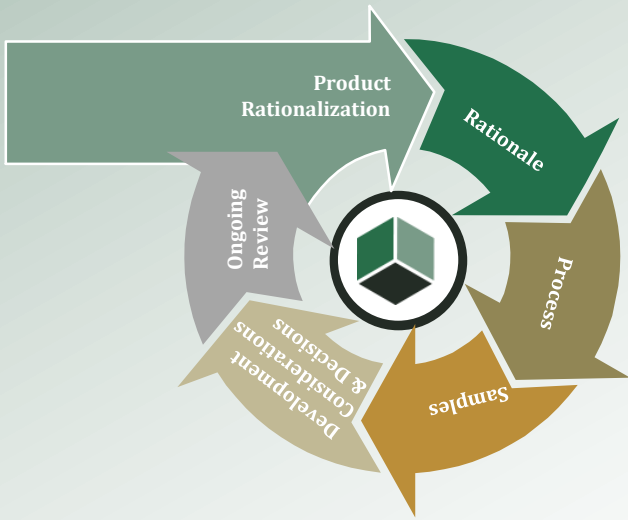


Rationale

Due to a shifting industry standard, demanding client expectations, and developing legal and regulatory requirements, financial institutions must reexamine their processes for providing recommendations. This begins with establishing a competitive product shelf that meets investors' needs. A well-defined product approval structure will assist in identifying products that will best help investor needs. Further, it will assist firms in evidencing a higher standard of care and oversight for recommendations to clients. Along with a strong governance framework over the recommendation process, formalizing the process for determining which products may be added to—or remain on—the product shelf must be well documented, robust and reviewed regularly.

Process





Key Considerations and Decisions

- Firms must identify key qualitative and quantitative factors for neutral and consistent method to score each product type.
- Reliable, independent, conflict-free third-party data should be considered and included in the scorecard calculation.
- Use competitor sets or categorical benchmarks to evaluate the competitiveness of factors. Maintain a consistent approach to weightings (e.g., quantitative vs. qualitative, key factors, etc.) and scoring (e.g., anchor vs. median).
- Document a risk-based product rationalization and approval methodology in its entirety.
- Ensure weightings do not allow for proprietary product bias.
- Upon full implementation, the completed process, including all scorecards, written analysis, and supporting product information should be reviewed and validated by an independent third-party or an internal audit function on a regular basis.

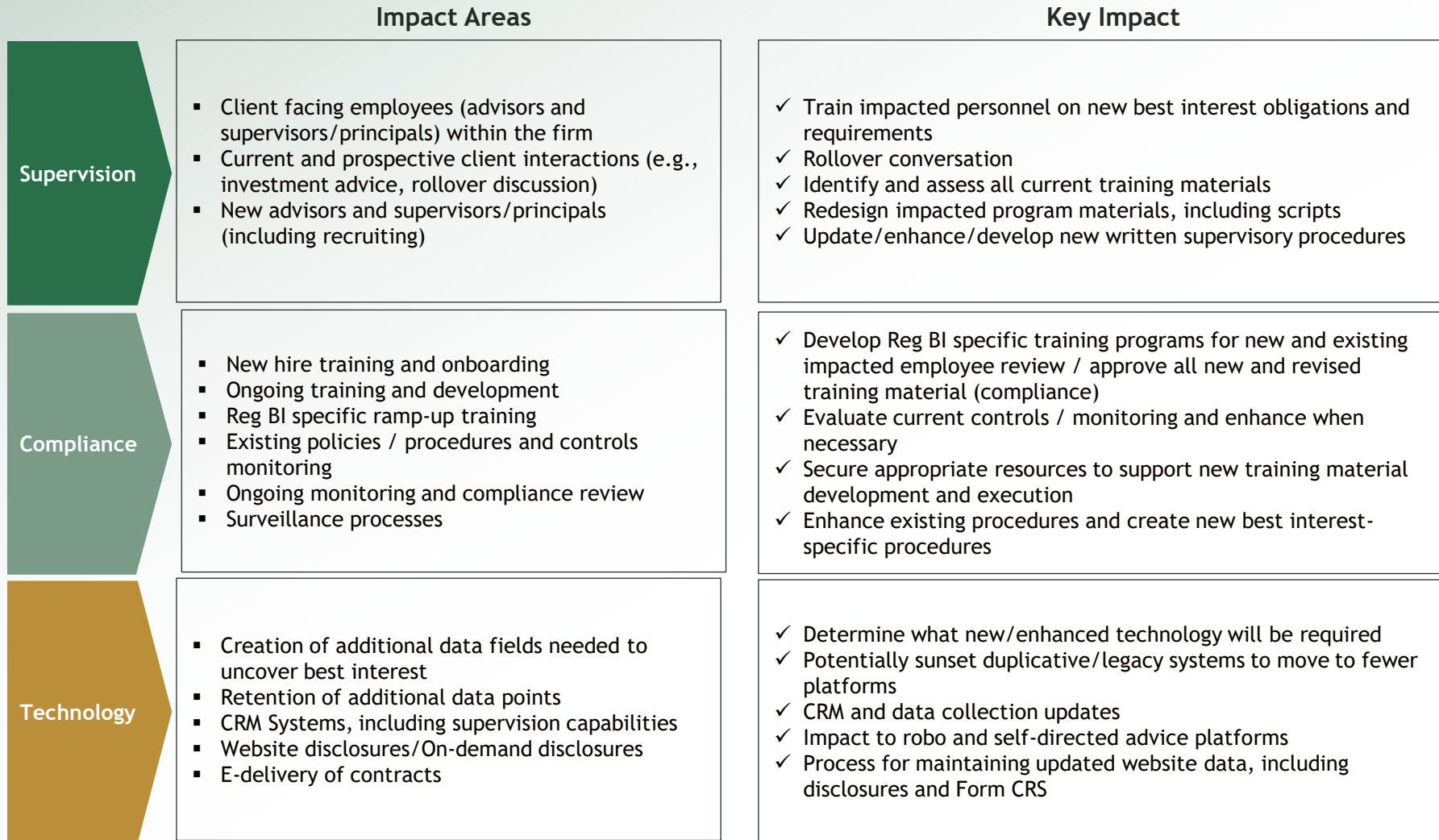
Sample Product Review Factors

Quantitative Factors	Qualitative Factors
<ol style="list-style-type: none"> 1. Performance 2. Fees/Pricing 3. Risk 4. Fund Average 	<ol style="list-style-type: none"> 1. Risk 2. Standard Features 3. Differentiated Features 4. Service Levels

Ongoing Review

The Product Approval Committee should periodically review the product rationalization process and methodology. It must adequately capture key quantitative and qualitative factors, relative weightings, and stakeholder perspectives required for each product type the firm would like to maintain on its product shelf and consider for addition to its product shelf. Reviews and reporting can be conducted by Compliance or Internal Audit.

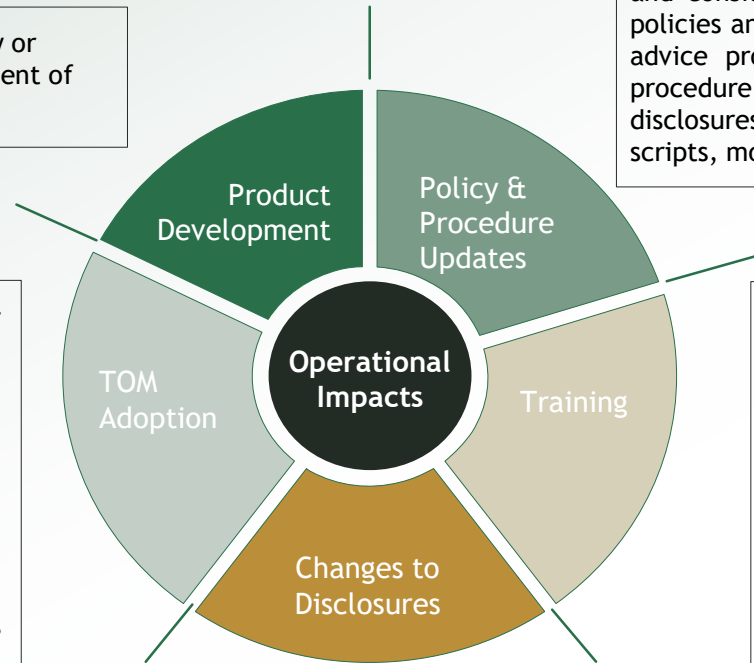
Implementation requires development and enhancement of processes and technology



Key Considerations

Firms should consider whether new or existing products align with the intent of the Best Interest Standard.

Firms will need to review internal policies and consider the need for updates or new policies and procedures relating to sales and advice provided to customers. Policy and procedure updates may be related to disclosures, sales practices, call center scripts, monitoring of accounts, etc.



Firms should examine impacts to transactional and fee-based business.

- It is critical that firms understand and assess
 - Operational and supervisory impacts for monitoring best interest recommendations
 - Operational and technological challenges of “point of recommendation” disclosure and other potential impacts to your clients.
- Firms may find that new entrants, such as hybrid firms will disrupt new business.
- What compensation models will be impacted and how will changes be addressed.
- Firms that use proprietary products will have to perform an impact assessment and develop clear controls to ensure best interest recommendations.

The way in which financial professionals and their customers communicate will be impacted.

- Firms will need to train staff and provide clear guidance on permissible products and services, and develop methods to convey such information to customers.
 - This could be onerous and potentially cause confusion, particularly if a client owns multiple types of accounts where different duties of care apply.
- Training will require significant enhancement as relates to disclosures, updated policies, and products.

Proposed disclosure requirements could prove challenging as relevant fee and cost information is typically not easily accessible in a centrally located database.

- Firms should begin to identify gaps in data collection and identify ways to collect fee information, including contracts, amendments, and prospectuses.
- Systems and processes will need to be enhanced to detect and block certain products that are not allowed.

AI Products

- ▶ Increased focus on demonstrating due diligence of alternatives when recommending to retail clients
 - ▶ SEC exams focus on private wealth managers recommending alternatives
 - ▶ Concern with fees, client sophistication, illiquidity, and risks
 - ▶ Attention to adequacy of disclosures

Customer Relationship Summary

- ▶ 2 pages (4 if dual registrant)
- ▶ Geared to retail audience, prescribed language in each section
- ▶ Summary of firm's offer
 - ▶ Services
 - ▶ Fee structure
 - ▶ Conflicts of interest
 - ▶ How professionals are compensated
- ▶ Contains “conversation starters”
- ▶ Public document with searchability

CRS Delivery Requirements

- ▶ File and post on website by June 30, 2020
- ▶ Deliver to all current RETAIL clients by July 30, 2020
- ▶ If Broker Dealer, thereafter:
 - ▶ Prospect—if recommendation made—“call to action” including “hire me”
 - ▶ Current client when recommending or enacting:
 - ▶ Security transaction, new account type, change in strategy, or moving retirement funds
- ▶ If Investment Advisor, thereafter:
 - ▶ Prospect: At time the ADV 2A is delivered - when Investment Agreement is signed
 - ▶ Client: When opening new account type, making change in strategy, or moving retirement funds

Questions & Answers

Reg BI Resources:

- ▶ **Bates Compliance Reg BI Resource Pages & Library, including regulator priorities, and state/federal developments**
- ▶ <https://www.batesgroup.com/service/regulation-best-interest>
- ▶ <https://www.batesgroup.com/news/ocie-to-prioritize-reg-bi-compliance-in-2020-examinations>
- ▶ <https://www.batesgroup.com/news/finra-reorganizes-for-more-coordinated-exams-highlights-priorities-for-2020>
- ▶ <https://www.batesgroup.com/search/eyJyZXN1bHRfcGFnZSI6InNlYXJjaFwvaW5kZXgiLCJrZXI3b3Jkcyl6IjFZyBCSSJ9>

- ▶ **SEC FAQs - Reg BI**
- ▶ <https://www.sec.gov/tm/faq-regulation-best-interest>

- ▶ **FINRA Reg BI site and check list:**
- ▶ <https://www.finra.org/rules-guidance/key-topics/regulation-best-interest>

- ▶ **FINRA Report on Conflicts of Interest**
- ▶ <https://www.finra.org/sites/default/files/Industry/p359971.pdf>

- ▶ **FORM CRS Checklist from Investment Advisor Association (IAA)**
- ▶ <https://www.investmentadviser.org/resources/new-conduct-rules-resources/form-crs-sample> (Scroll to the bottom of the page. You do not need to sign in.)

Thank you for joining us! Contact Us:

Bates Group experts and consultants have deep industry knowledge and a wide range of invaluable experience. This combination of experience and broad-ranging skill sets helps us provide unique insights and services to our clients. Our Compliance Solutions and Financial Services Regulatory team is comprised of a diverse group of experienced professionals with backgrounds in compliance, regulation and in the broker-dealer and RIA firms, including:

<i>United States Securities & Exchange Commission</i>	<i>FINRA (NASD & New York Stock Exchange Regulation)</i>	<i>Federal Reserve Board of Governors (Division of Banking Supervision & Regulation)</i>	<i>New York Stock Exchange American Stock Exchange National Stock Exchange (Chicago)</i>
<i>US Department of Commerce US Department of the Treasury</i>	<i>Federal Reserve Bank of NY Federal Home Loan Mortgage Corp. (Freddie Mac)</i>	<i>State Departments of Banking, Finance and Insurance Insurance Regulatory Examiners Society</i>	<i>Former Chief Compliance Officers & Managing Directors of Broker-Dealers and RIAs</i>

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