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Documentation Under Reg BI – Requirements, Expectations and Reasonable Practices

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Compliance professionals frequently incorporate interpretive guidance issued by SEC and FINRA Staff as they develop and maintain their compliance programs. Such guidance also helps firms prepare for the inevitable regulatory examinations, as the guidance often lays out expectations about how firms can demonstrate their implementation of applicable rules. Concerningly, however, guidance issued by the staff of regulators also can have the effect of undermining delicate and deliberate balances that that Commission itself has adopted. This consequence seems to be implicated with respect to Regulation Best Interest (Reg BI) where there is an increasingly wide gap between the records that broker dealers (BDs) must create in order to be in compliance with the rule, and the records that examiners expect firms produce to demonstrate compliance with the rule.

Background—Reg BI

Essentially, Reg BI requires BDs to act in the best interest of their retail investors (referred to as "customers" in this article) at the time they recommend any securities transactions or investment strategies involving securities.[1]

Reg BI is comprised of four component obligations and an express recordkeeping requirement. Those five duties are the following:

- *Disclosure Obligation*: At the time of a recommendation, BDs and registered representatives (RRs) must make full and fair written disclosure of all material facts relating to the scope and terms of the relationship with the customer and all material facts relating to any conflicts of interest that are associated with the recommendation.
- *Care Obligation*: In making recommendations to customers, BDs must exercise reasonable diligence, care, and skill to understand the potential risks, rewards, and costs associated with the recommendation. They must also consider the risks, rewards, and costs in light of the customer's investment profile and have a reasonable basis to believe that the recommendation is in that particular customer's best interest and does not place the broker's interest ahead of the customer's interest.
- *Conflict of Interest Obligation*: BDs must establish, maintain, and enforce written policies and procedures reasonably designed to identify, disclose, mitigate, and/or eliminate conflicts of interest relating to recommendations.
- *Compliance Obligation*: BDs must establish, maintain, and enforce written policies and procedures

reasonably designed to achieve compliance with Reg BI.

- *Record Creation and Retention*: BDs are obligated to make and keep current (i) the customer profile collected from and provided to the retail customer pursuant to Reg BI, and (ii) the identity of any RR responsible for the account, if any, and they must retain such records for 6 years.[2]

Documentation Requirements Under Regulation Best Interest

Four of the five duties of Reg BI have express documentation requirements; the Care Obligation does not, as it is a real-time duty to understand the investment, the customer, and the strategy.[3] The Commission did not forget to include a documentation requirement in the Care Obligation—rather, it recognized the excessive burden that such a duty would create and decided against imposing one. The Commission explained:

> [T]he Commission does not intend this to require, in practice, the creation of extensive new and potentially duplicative records for each and every recommendation to a retail customer. Instead, broker-dealers should be able to explain in broad terms the process by which the firm determines what recommendations are in its customers' best interests, and similarly to explain how that process was applied to any particular recommendation to a retail customer. However, we are not mandating that broker-dealers create and maintain a record of each such determination. Nonetheless, as noted above we are providing guidance suggesting that firms may wish to adequately document an evaluation of a recommendation and the basis for that recommendation in particular 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.
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> In addition, in response to requests from commenters for confirmation that the proposed record-making requirements do not contemplate broker-dealers needing to create and maintain records of why certain products were recommended over others on a recommendation-by-recommendation basis, we confirm that broker-dealers are not expected to maintain records comparing potential investments to one another so long as they are able to demonstrate that each individual recommendation actually made to a customer meets the requirements of Regulation Best Interest on its own. Regulation Best Interest applies to recommendations *made* to a retail customer, rather than to potential recommendations considered by the broker-dealer but not actually made to the customer.
> (emphasis in original; internal citations omitted)

This language from the Commission is straightforward and unambiguous: BDs *can* comply with their Care Obligation without creating any specific records, although it is prudent to create records in specific instances, such as for complex products, or where a recommendation may seem inconsistent with a customer's investment objectives on its face. Notably, these examples offered by the Commission are not specifically covered by the other obligations of Reg BI.

Documentation Expectations Under Regulation Best Interest

SEC Staff has repeatedly emphasized that it takes a much more expansive view than the Commission itself with respect to BDs' documentation creation and retention duties pursuant to the Care Obligation. The Staff has done so by bootstrapping the Care Obligation to the documentation requirements of the Compliance and Conflict of Interest Obligations.[4] In doing so, the Staff seemingly has elevated their own need to have a means of assessing a BD's compliance with Reg BI above the Commission's stated concern that BDs not be excessively burdened by recordkeeping requirements.

Reasonable Practices

It is tempting to point out that SEC Staff Bulletins are merely guidance from SEC Staff; they are not voted on by SEC Commissioners and do not have any independent "force or effect." While certainly true, this observation likely will provide little comfort to those who find themselves in the crosshairs of an SEC or FINRA examination (or in an arbitration where plaintiffs' counsel insist that such guidance have the force of law). As a practical matter, therefore, most broker-dealers will want to require that brokers document the basis for at least *some* recommendations.

Would it be even a better practice for BDs to require RRs to document the basis for all recommendations? While such an approach might be preferred by examiners, it is not without risk. Inevitably, some RRs will not document each recommendation, or will do so in a cursory fashion. In such events, regulators could find that the firm "failed to enforce" its policies and procedures. There also is a risk that the burden of documenting every recommendation will result in a diminution in the quality of documentation, leading to formulaic or even incorrect documentation that a regulator may later parse through and find fault with. The quality of the recommendations may also suffer, as RRs may be loathe to create custom documentation for each recommendation and may offer fewer strategies to minimize the time involved in documenting the alternatives.

Accordingly, the best approach for most broker-dealers is likely to be a middle-ground—requiring brokers to document only certain recommendations.

It bears noting that the Commission noted six times in the Adopting Release that a BD's compliance with the Care Obligation is evaluated as of the time of the recommendation and not in hindsight.[5] Examiners review recommendations after the passage of time, however, when the actual performance of securities or strategies may already be known. When a security or strategy has underperformed, contemporaneous documentation can be helpful to demonstrate the perspective at the time of the trade.[6]

What Recommendations Should Be Documented?

For firms that decide to require at least some documentation under the Care Obligation (which these authors recommend), where should they start? As noted above, the Commission advised that BDs should take a risk-based approach when deciding whether to document certain recommendations, and SEC Staff expanded the types of recommendation that they think would warrant documentation. Those circumstances include instances in which:

- the investment "appears inconsistent with" an investor's objectives;
- the recommendation poses a conflict of interest for the firm or broker;
- the recommendation involves a "significant investment decision" such as a rollover or choice of accounts; and
- the investment is complex, risky, or expensive.

With regard to this last category, the SEC has not provided any comprehensive definition of "complex" or "risky" products, but SEC Staff have listed as examples: inverse or leveraged exchange-traded products, investments traded on margin, derivatives, crypto asset securities, penny stocks, private placements, asset-backed securities, volatility-linked exchange-traded products, and reverse-convertible notes.

In addition to the categories highlighted by the SEC and Staff, BDs may wish to consider firm-specific factors that may either cause (i) an actual heightened risk of noncompliance with the Care Obligation; or (ii) a more challenging time demonstrating to regulatory examiners that they have met their duty. For example, depending on the particular facts and circumstances, some BDs might wish to impose recommendation-level documentation requirements for:

- RRs who are new to the BD;
- RRs whose conduct has been the subject of exceptions noted in branch or other internal reviews;
- RRs subject to recent customer complaints, particularly if the nature of the complaints is relevant to the duties under the Care Obligation;
- RRs with regulatory or disciplinary history, if the matter is relevant to the duties under the Care Obligation;
- RRs who use the same strategy or securities for an unusually high percentage of their customers;
- Branches or RRs selected at random, for a temporary period, as a way to test that they understand their duties and to confirm that their approaches are consistent with the process described in the firm's procedures; and
- Products/strategies that are new the market or to the BD even if not identified as complex or risky by the SEC or FINRA.

In addition to providing guidance to brokers as to *when* they should document a recommendation, BDs should consider *what* about the recommendation should be documented, and *how* they should document a recommendation. Indeed, in a January 2023 Risk Alert, the SEC's Division of Examination cited as "deficient" firm procedures that directed brokers to document the basis for their recommendations without providing guidance as to "the specific information to be gathered."[7] Some of the elements of the Care Obligation may not need to be documented on a trade-by-trade basis. For example, with respect to the Care Obligation's requirement that the person (BD or RR) making a recommendation understands the potential risks, rewards, and costs associated with the security or strategy, BDs can demonstrate that the RRs are trained in products or strategies by maintaining the content of product training and evidence of which RRs attended, being careful to monitor that the training has not become outdated as the product or market evolve.

Conclusion

Although it is not explicitly required, BDs are likely to have a difficult time defending their compliance with the Care Obligation in regulatory examinations if they do not document any of their securities recommendations. Firms are advised to adopt policies, procedures and practices that are based on the BD's own risk profile and tolerance for regulatory inquiry. That said, most BDs would be well advised to require that RRs document at least some of their recommendations, and BDs should also advise their RRs how and where they should document those recommendations.

[1] Exchange Act Rule 15l-1. As this article focuses on the documentation requirements of Reg BI, its summary of the aspects of the rule are provided at a very high level. Since Reg BI only applies to recommendations to retail investors, as Reg BI defines that term, this article addresses only recommendations made to such persons.

[2] Exchange Act Rules 17a-3(a)(35) and 17a-4(e)(5)

[3] The Disclosure Obligation requires firms to provide written disclosures to customers, and the Compliance and Conflict of Interest Obligations mandate the maintenance of written policies and procedures, all of which are subject to the recordkeeping requirements under Exchange Act Rule 17a-4.

[4] See excerpt from SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Adviser (April 20, 2023, updated April 22, 2024):

> **16. Should firms document the evaluation of reasonably available alternatives?**
> Although there is no requirement of such documentation, in the staff's view, it may be difficult for a firm to demonstrate compliance with its obligations to retail investors, or periodically assess the adequacy and effectiveness of its written policies and procedures, without documenting the basis for certain recommendations.

See also excerpts from SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (March 30, 2022):

> Regarding the consideration of factors other than cost:
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> > It 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.
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> Regarding retirement account rollover recommendations:
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> > In the staff's view, when making a rollover recommendation, 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 the recommendation.
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> Regarding the type of account that was recommended for a customer:
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> > Additionally, in the staff's view, 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 certain recommendations.

As with all Staff guidance, this bulletin notes that the views expressed therein do not constitute rules, regulations or statements of the Commission, have no legal force or effect, do not alter or amend applicable law, and create no new or additional obligations.

[5] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release 34-86031 (June 5, 2019) ("Regulation Best Interest Adopting Release").

[6] Documentation can be double-edged sword when defending civil matters, particularly in arbitration. Plaintiffs' counsel often parse through documentation to identify every possible other fact or rumor that might have been knowable to the RR or BD at the time of the trade (which efforts often exceed the "reasonable diligence, care and skill" requirements by the Care Obligation). Of course, counsel will argue that the absence of documentation is even more compelling evidence of a firm's failure, so there is no way to be protected with certainty.

[7] SEC Risk Alert: Observations from Broker-Dealer Examinations Related to Regulation Best Interest (January 30, 2023), at 3-4.

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