WILMERHALE

August 27, 2018

Stephanie R. Nicolas

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Via E-Mail to rule-comments@sec.gov

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Regulation Best Interest (SEC Release No. 34-83062; File No. S7-07-18)

Dear Mr. Fields:

Enclosed please find a letter from Robert W. Cook, President and Chief Executive Officer of the Financial Industry Regulatory Authority, to the Honorable Elizabeth Warren, the Honorable Sherrod Brown, and the Honorable Cory A. Booker of the United States Senate. This letter is responsive to the Securities and Exchange Commission's request for comment on proposed Regulation Best Interest.

Best regards,

Stephanie R. Nicolas

FINRA
Financial Industry Regulatory Authority

Robert W. Cook
President and Chief Executive Officer

August 3, 2018

The Honorable Elizabeth Warren
United States Senate
317 Hart Senate Office Building
Washington, DC 20510

The Honorable Sherrod Brown
United States Senate
713 Hart Senate Office Building
Washington, DC 20510

The Honorable Cory A. Booker
United States Senate
359 Dirksen Senate Office Building
Washington, DC 20510

Dear Senators Warren, Brown and Booker:

The Financial Industry Regulatory Authority (FINRA) appreciates the opportunity to respond to your inquiries regarding FINRA's role in implementing the Securities and Exchange Commission's (SEC) proposed Regulation Best Interest (Reg BI).[1] As you observed, FINRA is a self-regulatory organization responsible for supervising broker-dealers pursuant to the Securities Exchange Act of 1934 (Exchange Act) and subject to the SEC's oversight. FINRA fulfills this mandate by (among other things) adopting rules to supplement those of the SEC and examining for and enforcing compliance with FINRA rules, SEC rules applicable to broker-dealers, and applicable provisions of the Exchange Act.[2] Accordingly, as you indicate, FINRA will have a role in supervising broker-dealer compliance with Reg BI, if adopted.

Your letter poses a number of questions about FINRA's interpretation of proposed Reg BI, indicating that whether or not the rule will fulfill the SEC's stated goal "may depend largely, if not almost entirely, on the way that FINRA interprets the rule and applies it in its disciplinary actions and arbitration proceedings." Although, as noted above, FINRA would have a role in supervising compliance with Reg BI – in addition to the SEC, which also examines broker-dealers for compliance with its rules – FINRA does not independently interpret the SEC's rules. Rather, FINRA examines broker-dealers for compliance with the SEC's rules and enforces those rules in a manner consistent with the SEC's authoritative interpretations.

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[1] *See* Proposed Regulation Best Interest, Exchange Act Release No. 83062 (Apr. 18, 2018), 83 FR 21574 (May 9, 2018) (Reg BI Release).

[2] FINRA does not enforce the Investment Advisers Act of 1940 (Advisers Act) or the rules promulgated thereunder, which apply to investment advisers, as defined in the Advisers Act.

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In the normal course of its examination and enforcement operations, when FINRA has a question about the proper interpretation of an SEC rule, or when FINRA intends to take action for which an interpretation of an SEC rule is necessary, we consult with the SEC staff to ensure that FINRA's regulatory program remains faithful to the SEC's interpretations.[3] Such consultation also ensures that FINRA's approach is consistent with any positions being taken concurrently by the SEC when it examines for and enforces compliance with the same SEC rule. In addition, FINRA's examination and enforcement programs are themselves subject to examination by the SEC, which may include a review of whether FINRA is acting in accordance with the SEC's interpretations of its rules. Accordingly, interpretive questions concerning the requirements of Reg BI, such as those presented in your letter, will be resolved in practice by the SEC, not FINRA, and we will defer to the SEC with respect to those questions.[4]

With respect to your question regarding elements of proposed Reg BI that might benefit from further clarification if the rule is finalized, we note that, as part of its ongoing and extensive efforts to solicit input on its proposals, the SEC has requested comment on many aspects of the rule, including the scope of "best interest," the meaning of "retail customer," the extent of conflict mitigation that would be necessary regarding financial incentives, and the requirement to consider reasonably available alternatives to, and costs of, a recommended security.[5] We would anticipate that, as is normally the case, any final rule will include or be accompanied by additional explanations, interpretations and guidance regarding these and other topics, which would be helpful in further clarifying the requirements of Reg BI. As with any new SEC rule, to the extent interpretive issues exist upon any adoption of Reg BI, FINRA would seek guidance from the SEC in conducting our supervision of broker-dealers' compliance with the rule.

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[3] For example, from time to time, and to facilitate broker-dealer compliance, FINRA publishes information pertaining to the application of SEC rules. We do so only after consultation with the SEC staff to ensure that the information comports with the SEC's interpretations of its rules.

[4] With respect to the application of Reg BI in arbitration proceedings, as discussed below, FINRA acts as a neutral administrator of its arbitration forum and therefore does not use that forum to interpret SEC rules and does not have input into arbitration decisions.

[5] *See, e.g.*, Reg BI Release, 83 FR at 21616 (requesting comment on the "best interest" standard in Reg BI and the scope of the "best interest" provision in the component duty of care obligation), 21595-98 (discussing the definition of "retail customer" for purposes of Reg BI), 21618 (discussing whether Reg BI appropriately identifies the types of financial incentives that should be eliminated or mitigated and disclosed), 21588-89 and 21591 (discussing and requesting comment on Reg BI's treatment of cost as an important factor in the analysis of whether a recommendation is in a retail customer's best interest).

With respect to your question regarding how proposed Reg BI and its companion proposals[6] may differ from the current requirements applicable to broker-dealers, including under FINRA's suitability rule (FINRA Rule 2111), FINRA has preliminarily identified several areas where the SEC's proposals will augment and enhance such current requirements, and additional areas may become apparent through the rulemaking process. As described below, the proposals overall clarify, and in certain significant areas extend, the requirements under existing rules that apply to broker-dealers:

- *Conflicts of Interest:* To provide clarity and regulatory certainty, proposed Reg BI would require that broker-dealers establish, maintain and enforce written policies and procedures reasonably designed to identify each material conflict of interest and disclose or eliminate the conflict and, for conflicts arising from financial incentives, disclose and mitigate, or eliminate, those financial conflicts. In addition, a firm would violate Reg BI and its conflicts obligation if its recommendation was predominantly motivated by the firm's self-interest and not the customer's best interest.[7]

  While FINRA has repeatedly emphasized the importance of identifying and managing conflicts and has a number of rules that address discrete conflicts of interest,[8] there is currently no similarly broad conflicts provision in FINRA rules, including the suitability rule.

- *Disclosures:* Proposed Form CRS would require disclosure of information to retail customers about services, fees, the applicable standard of conduct, specified conflicts of interest, and whether the firm and its financial professionals have reportable legal or disciplinary events. Proposed Reg BI would also require written disclosure before or at the time of a recommendation of the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest associated with the recommendation.

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[6] *See* Proposed Form CRS Relationship Summary, Advisers Act Release No. 4888 (Apr. 18, 2018), 83 FR 21416 (May 9, 2018), 83 FR 23848 (May 23, 2018); Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 4889 (Apr. 18, 2018), 83 FR 21203 (May 9, 2018).

[7] *See* Reg BI Release, 83 FR at 21588.

[8] *See, e.g.,* FINRA Report on Conflicts of Interest (October 2013), www.finra.org/sites/default/files/Industry/p359971.pdf.

A number of FINRA rules have discrete disclosure requirements;[9] however, FINRA rules do not have a comparable, express broad-based disclosure requirement.

- *Best Interest Standard:* Proposed Reg BI explicitly imposes a "best interest" standard, making clear that a broker-dealer cannot put its interests ahead of the interests of its customers.[10] While FINRA's suitability rule implicitly requires a broker-dealer's recommendations to be consistent with customers' best interests,[11] the SEC's proposed best interest standard explicitly establishes the customer's best interest as an overarching standard of care for broker-dealers.

- *Diligence Standards:* Proposed Reg BI requires broker-dealers to exercise reasonable diligence, care, skill, and prudence, standards that draw on similar concepts from the Department of Labor's (DOL) fiduciary rule.[12] FINRA's suitability rule requires that a broker-dealer or associated person use reasonable diligence to make a suitability determination.

- *Alternatives:* Proposed Reg BI explicitly requires broker-dealers to consider "reasonably available alternatives" to a recommended security and justify any choice of a more costly product. The SEC's proposal states that, "where a broker-dealer is choosing among identical securities with different cost structures, . . . it would be inconsistent with the best interest obligation for the broker-dealer to recommend the more expensive alternative for the customer, even if the broker-dealer had disclosed that the product was higher cost and had policies

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[9] *See, e.g.,* FINRA Rule 2210 (Communications with the Public); FINRA Rule 2241 (Research Analysts and Research Reports); FINRA Rule 2330 (Members' Responsibilities Regarding Deferred Variable Annuities); FINRA Rule 2341 (Investment Company Securities); FINRA Rule 2342 ("Breakpoint" Sales).

[10] *See,.e.g.,* Reg BI Release, 83 FR at 21587.

[11] *See Regulatory Notice 12-25* (May 2012) ("The suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests."); *see also Raghavan Sathianathan*, Exchange Act Release No. 54722, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006); *Scott Epstein*, Exchange Act Release No. 59328, 2009 SEC LEXIS 217, at *40 n.24 (Jan. 30, 2009) ("In interpreting the suitability rule, we have stated that a [broker's] 'recommendations must be consistent with his customer's best interests.'").

[12] *See* Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice, 81 FR 20946 (Apr. 8, 2016).

and procedures reasonably designed to mitigate the conflict . . . ."[13] Although case law and FINRA guidance establish cost and available alternatives as factors to consider as part of a FINRA suitability assessment, particularly regarding mutual fund share classes, proposed Reg BI expressly establishes the significance of these factors.[14]

- *Control Element in Excessive Trading Cases:* Proposed Reg BI removes the "control" element for purposes of quantitative suitability, which would make this obligation more enforceable. FINRA's suitability rule requires a broker-dealer with control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together. The SEC's proposed Reg BI would require a firm to exercise reasonable diligence, care, skill, and prudence to have a reasonable basis to believe that a series of recommended transactions is in the retail customer's best interest, even if the firm does not "control" the account. (FINRA also has proposed to eliminate the control requirement from our suitability rule.[15])

- *Adviser Description:* Proposed Form CRS precludes a broker-dealer and its representatives from describing themselves as "advisers" or "advisors" unless they are dually registered as investment advisers and engage in some activity as advisers. FINRA rules do not contain such a prohibition.

Your letter also inquired about the enforcement remedies available under the SEC's proposed Reg BI. The SEC examines for and enforces compliance with its rules, and we would anticipate that it will do so with respect to Reg BI. As noted above, FINRA also is charged with examining for and enforcing compliance with SEC broker-dealer rules. Therefore, FINRA also would examine broker-dealers and enforce compliance with Reg BI and its companion broker-dealer rules, adhering to SEC guidance and interpretations as noted above. A broker-dealer that does not comply with the best interest standard or other aspects of the proposals thus could be subject to an enforcement action by FINRA or the SEC. These enforcement actions might result in a fine, disgorgement or restitution, suspension or expulsion from the industry, or other remedial actions.

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[13] Reg BI Release, 83 FR at 21612-13.

[14] *See, e.g., Regulatory Notice 12-25* (discussing cost as important factor to consider in suitability determination).

[15] *See Regulatory Notice 18-13* (Quantitative Suitability) (Apr. 20, 2018).

As to your question regarding how this enforcement regime would differ from enforcement of FINRA's existing suitability standards or from enforcement of the DOL's fiduciary rule, FINRA is the regulator primarily responsible for interpreting, examining for and enforcing compliance with our suitability rule. It is our understanding that neither FINRA nor the SEC would have had explicit enforcement authority over the DOL's 2016 rule.

An injured customer also could seek redress directly against a broker-dealer or its associated persons for violations of Reg BI. We believe that such customer claims ordinarily would be resolved through the same process that is used for customer claims under FINRA's existing suitability rule – *i.e.*, those claims would typically be resolved through arbitration (usually in FINRA's arbitration forum).[16] FINRA's arbitration forum is operated pursuant to rules that have been filed with and approved by the SEC (after publication in the Federal Register and a finding by the SEC that such rules are in the public interest), and that are designed to create a process that is fair, expeditious, independent and cost-effective for claimants.[17] As part of its oversight of FINRA, the SEC regularly examines FINRA's administration of the arbitration forum.

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[16] Most broker-dealers require customers opening accounts to agree in writing to arbitrate disputes concerning the account in the FINRA forum or another forum to which the parties agree. FINRA does not require broker-dealers or their customers to enter into predispute arbitration agreements. FINRA's rules do establish certain disclosure and related customer protection requirements regarding the use of such agreements.

In the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress authorized the SEC to prohibit, or impose conditions or limitations on, the use of mandatory arbitration clauses in customer account agreements in the securities industry. FINRA rules preserve the ability of customers to bring class actions in state or federal court when a private right of action exists. However, the SEC has indicated that proposed Reg BI is not intended to create any new private right of action. *See* Reg BI Release, 83 FR at 21584. In response to your question, we understand customer claims regarding violations of the DOL's 2016 fiduciary rule would also have been handled in arbitration (except where class action litigation might be available and pursued).

[17] *See generally* FINRA Code of Arbitration Procedure for Customer Disputes and Code of Arbitration Procedure for Industry Disputes, available at www.finra.org/arbitration-and-mediation/code-arbitration-procedure. Under the Code, any party to an arbitration by a customer can ensure that all arbitrators on the matter are "public" arbitrators, which generally means they do not have any significant affiliation with the financial industry. A customer who is awarded damages in an arbitration proceeding can have the award confirmed in court, and then would have access to the same collection tools as if the customer had been awarded a judgment in court. In addition, if a firm or registered individual fails to pay an arbitration award, FINRA suspends them from the brokerage business.

Arbitration is equitable in nature. As a matter of policy, arbitrators in the forum are expected to consider the law and rules pertinent to a particular case, which would include Reg BI if adopted. FINRA's arbitration forum is operated separately from FINRA's regulatory and enforcement programs, and decisions in the forum do not create precedential interpretations of SEC or FINRA rules. FINRA's primary role in the arbitration process is to administer cases brought to the forum in a neutral, efficient and fair manner. As such, FINRA does not take positions in pending arbitration matters, and it therefore would not have any input into the outcome of arbitration proceedings involving Reg BI.

Your letter also seeks information on feedback that FINRA has provided to the SEC on proposed Reg BI. FINRA has previously indicated its support for rulemaking by the SEC to address the standards of care applicable to broker-dealers that serve retail investors, and we commend the SEC for undertaking this initiative. FINRA has not submitted and is not currently planning to submit a comment letter to the SEC on the proposal, although we will provide any technical assistance that may be requested by the SEC. SEC and FINRA staff have regular communications regarding our respective regulatory programs, the SEC's oversight of FINRA, and developments within the industry. Since the issuance of the proposal, some of these communications naturally have touched on topics related to Reg BI, but discussions of the proposal to date have been of limited scope and at a high level, including a May meeting with the Chairman and staff at which we did identify a recent law firm article that highlights the relationship between Reg BI and ERISA requirements.[18] FINRA also has invited the SEC Chairman, Commissioners, and agency officials to address FINRA members and FINRA's Board of Governors since the issuance of the proposals. For example, Chairman Jay Clayton was a keynote speaker at the 2018 FINRA Annual Conference on May 22, where I interviewed the Chairman.[19] In addition, the FINRA Board of Governors met on July 18 and 19, and I invited Commissioners Robert J. Jackson Jr. and Hester M. Peirce to address the Board. During these presentations, the Chairman and Commissioners provided their thoughts on a variety of topics, including the proposals.

FINRA's work to advance its dual mission of investor protection and market integrity is an integral part of the oversight of the securities industry. We look forward to working with the SEC, Congress and our other stakeholders to further this mission. Over the years, FINRA has served as a resource for the SEC and the DOL, providing information and

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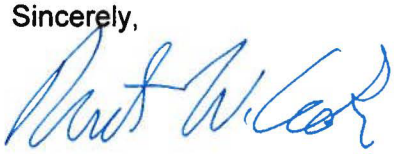
[18] *See* www.groom.com/resources/fiduciary-proposal-episode-iii-revenge-of-the-sec/.

[19] *See* www.finra.org/industry/conversation-sec-chairman-jay-clayton. Director of Trading and Markets Brett Redfearn delivered a keynote address on proposed Reg BI at the same event. *See* www.sec.gov/news/speech/redfearn-remarks-finra-annual-conference-052218.

technical assistance regarding FINRA's supervision of the broker-dealer industry, and we will continue to do so.

If you have any questions, please do not hesitate to contact me at [redacted], or your staff may contact Greg Dean, Senior Vice President, Office of Government Affairs at [redacted]. In addition, we would be happy to meet with you or your staff to discuss this matter further.

Sincerely,



Robert W. Cook
President and Chief Executive Officer