Keeping up with the regulators: How to build an effective compliance programme to satisfy the Best Interest care obligation

Received (in revised form): 16th August, 2024

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ABSTRACT

Over the past couple of years, the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) have significantly increased their Regulation Best Interest (Reg BI) enforcement efforts. Broker-dealers will need to act fast, as the pace of enforcement picks up and regulators issue guidance regarding their expectations for broker-dealers and their associated persons. This paper is intended for legal and compliance professionals designing a Reg BI compliance programme. It draws from recent SEC and FINRA guidance and enforcement actions, and it highlights some practical issues as well as potential solutions. The paper begins by discussing the differences between Reg BI and the Advisers Act fiduciary standard. It then provides some general considerations regarding the scope and application of Reg BI. The paper continues with an analysis of recent guidance and enforcement actions related to the care obligation, which has been a focus for both the SEC and FINRA. Finally, the paper concludes with some commentary on Reg BI issues related to the use of artificial intelligence by broker-dealers.

Keywords: Regulation Best Interest, broker-dealers, investment recommendations, artificial intelligence, Securities and Exchange Commission, FINRA

DOI: 10.69554/LARK2852

INTRODUCTION

It has been nearly five years since the US Securities and Exchange Commission ('SEC' or 'the Commission') adopted Regulation Best Interest (Reg BI) to enhance the standard

Journal of Financial Compliance
Vol. 8, No. 2 2024, pp. 131–143

2398-8053 (2024)

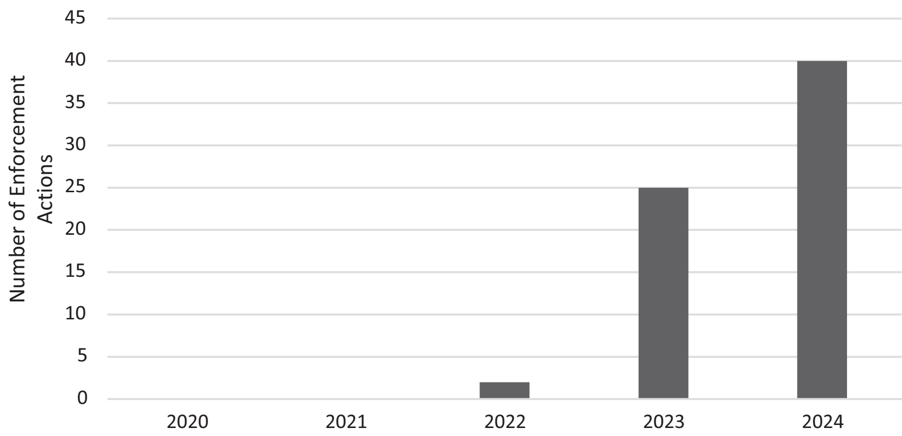

Figure 1 SEC and FINRA enforcement actions related to the care obligation, included on FINRA's website as of 18th October, 2024

of conduct applicable to broker-dealers when they make recommendations involving securities transactions or strategies to retail customers.[1] For the first few years after the SEC adopted Reg BI, enforcement activity by the US regulators was modest. Beginning in 2023, however, the SEC and Financial Industry Regulatory Authority (FINRA) significantly increased their enforcement efforts, with a particular focus on Reg BI's care obligation (see Figure 1). At the same time, both the SEC and FINRA have published detailed guidance on applicable regulatory requirements, best practices and common deficiencies.[2] The lessons from these enforcement actions and published guidance will be critical for broker-dealers (or 'firms') and compliance professionals to consider as they work to maintain an effective and up-to-date compliance programme.

This paper offers suggestions for designing and maintaining a Reg BI compliance programme, with a focus on the care obligation. To do so, it draws on recent SEC and FINRA guidance and enforcement actions and highlights some practical issues as well as potential solutions. First, the paper starts with a discussion of the differences between Reg BI's 'best interest' standard and a 'fiduciary' standard. Secondly, it discusses general considerations regarding the application of Reg BI. Next, it addresses key areas of regulatory focus and how compliance professionals and firms can stay ahead of the regulators in implementing programmes to comply with the care obligation. Finally, it addresses special considerations that compliance professionals should be mindful of relating to the use of artificial intelligence.

'BEST INTEREST' VERSUS 'FIDUCIARY' OBLIGATION

Much of the debate related to Reg BI before it was finalised in 2019 focused on whether it would be appropriate to impose a fiduciary standard on broker-dealers that is comparable to the standard applicable to investment advisers under the US Investment Advisers Act. Around that time, SEC Commissioner Hester Peirce delivered a speech entitled 'What's in a Name? Regulation Best Interest v. Fiduciary', in which she compared Reg BI (then only a proposed rule) with the SEC's proposed interpretation of the fiduciary standard under the Investment Advisers Act.[3] Her conclusion was that there was little space between proposed Reg

BI and a fiduciary standard. Some critics, however, (in particular certain state regulators) disagreed and argued that only a fiduciary standard could adequately protect retail investors.[4]

As will be clear throughout this paper, the reality is much more complicated, and in the view of the authors, it could be a costly mistake to assume that because the two standards are different, Reg BI imposes less stringent requirements. In a recent SEC bulletin on the care obligation, the SEC staff stated that although:

> the specific application of Reg BI and the IA fiduciary standard may differ in some respects and be triggered at different times, in the staff's view, they generally yield substantially similar results in terms of the ultimate responsibilities owed to retail investors.[5]

In one important way, the reach of Reg BI is more limited than the fiduciary obligation. Specifically, unless a broker-dealer has undertaken an affirmative monitoring obligation, the Reg BI obligation is limited in time to the moment of recommendation, whereas the investment adviser fiduciary duty applies to the entire relationship between adviser and client.[6]

But in other ways, the Reg BI standard can be more demanding and also more difficult to comply with. First, while both standards are 'principles-based', the Best Interest standard establishes *minimum* obligations that are generally more prescriptive than the fiduciary obligations of investment advisers.[7] Second, in many cases, advisers are able to address conflicts of interest through full and fair disclosure and informed consent, while broker-dealers must have policies and procedures that are reasonably designed to identify, disclose and mitigate conflicts that create an incentive for a broker-dealer's natural associated persons (APs) to place the interest of the broker-dealer or AP ahead of the interest of the retail customer. And in some cases, conflicts must be eliminated and cannot be addressed through disclosure and mitigation alone. These two differences should be at the forefront of the minds of legal and compliance professionals designing a compliance programme.

GENERAL CONSIDERATIONS REGARDING THE APPLICATION OF REG BI

Reg BI is codified in Rule 15*l*-1 under the Securities Exchange Act of 1934 ('Exchange Act').[8] Reg BI contains a 'general obligation' that is satisfied if and only if a broker-dealer complies with four component obligations: the care obligation, the disclosure obligation, the conflict of interest obligation, and the compliance obligation.[9] Crucially, Reg BI applies only if certain triggers are satisfied. Specifically, there must be a 'recommendation' to a 'retail customer'. An effective compliance programme will be attentive to Reg BI triggers so that natural person APs comply with Reg BI whenever Reg BI is operative.

'Retail customer'

The starting point in determining whether Reg BI applies is whether the customer is a 'retail customer'. Under 15*l*-1(b)(1), 'retail customer' means:

> a natural person, or the legal representative of such natural person who: (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer, or a natural person who is an associated person of a broker or dealer; and (2) uses the recommendation primarily for personal, family, or household purposes.[10]

The term 'use' is defined very broadly. A retail customer 'uses' a recommendation when: (1) the retail customer opens a brokerage account with the broker-dealer, regardless of whether the broker-dealer receives compensation; (2) the retail customer has an existing account with the broker-dealer and receives a recommendation from the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation; or (3) the broker-dealer receives or will receive compensation, directly or indirectly as a result of that recommendation, even if that retail customer does not have an account at the firm.[11]

The Commission interprets the term 'legal representative' to only cover non-professional (ie non-regulated) legal representatives.[12] If a legal representative is a regulated financial services industry professional, the customer would not be a 'retail customer'. However, if a regulated financial services industry professional is acting in a personal capacity for his or her own account, the individual is considered a retail customer for purposes of Reg BI.[13] The status of family offices also raises interesting questions. Given the unique status of these customers, the SEC has provided no-action guidance regarding the meaning of 'retail customer' in the family office context.[14]

'Recommendation'

The next critical question is whether the firm or its AP has made a 'recommendation'. The determination of whether there is a recommendation that triggers Reg BI turns on the 'facts and circumstances of the particular situation and therefore, whether a recommendation has taken place is not susceptible to a bright line definition'.[15] The SEC has said that factors relevant in determining whether a recommendation has taken place include whether the recommendation 'reasonably could be viewed as a call to action' and 'reasonably would influence an investor to trade a particular security or group of securities'.[16] The more individually tailored a communication is to a specific customer or targeted group of customers, 'the greater the likelihood that the communication may be viewed as a recommendation'.[17]

Dual-hatted personnel

For dual-hatted personnel, the application of Reg BI is more complicated. For example, whether Reg BI or the Investment Advisers Act applies depends on a facts and circumstances analysis, with no one factor being determinative.[18] The Commission considers, among other factors, the type of account, how the account is described, the type of compensation, and the extent to which the dually registered firm and financial professional made clear to the customer or client the capacity in which they were acting.[19] Note that, in making account recommendations, a dually registered financial professional would need to take into consideration the spectrum of accounts that they can offer, and not just brokerage accounts.[20] An individual who is only registered with a broker-dealer is not required to take into consideration both brokerage and advisory accounts, even if their firm is dually registered, but of course, the individual still must have a reasonable basis to believe that the recommended account is in the best interest of the retail customer.[21] For personnel who are dual-hatted with a broker-dealer and investment adviser, an effective compliance programme will need to clearly describe: (1) when Reg BI or the Advisers Act fiduciary standard applies to a particular communication; and (2) whether the differences between the two standards require different compliance protocols.

THE CARE OBLIGATION: AREAS OF REGULATORY FOCUS AND HOW TO STAY AHEAD OF THE REGULATORS

The care obligation has been an area of intense focus in recent SEC and FINRA examinations and enforcement actions as well as SEC and FINRA interpretive guidance. This obligation has three underlying components: reasonable-basis suitability, customer-specific suitability and quantitative suitability.[22]

- *Reasonable-basis suitability* requires a broker-dealer or AP to understand the potential risks, rewards and costs associated with a recommendation and have a reasonable basis to believe that the recommendation could be in the best interest of *at least some* retail customers.[23] The 'reasonable basis' requirement is intended to incorporate firms' obligations under FINRA 'reasonable-basis suitability' requirements to conduct due diligence on product offerings and, based on that diligence, develop an understanding that a product may be suitable for at least some customers. The Commission has stated that:

  > [w]hile we stress the importance of understanding the potential risks, rewards, and costs associated with a recommended security or investment strategy, as well as other factors depending on the facts and circumstances of each recommendation, we do not intend to limit or foreclose broker-dealers from recommending complex or more costly products or investment strategies where the broker-dealer has a reasonable basis to believe that a recommendation could be in the best interest of at least some retail customers *and the broker-dealer has developed a proper understanding of the recommended product or investment strategy*.[24]

- *Customer-specific suitability* requires the broker-dealer or AP to have a reasonable basis to believe that a recommendation is in the best interest of a particular retail customer based on their investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker-dealer or AP ahead of the interest of the retail customer.[25]
- *Quantitative suitability* focuses on whether a series of recommended transactions is excessive in light of the retail customer's investment profile and whether the transactions place the financial or other interest of the broker-dealer or AP making the recommendation ahead of the interests of the retail customer.[26]

In practice, in order to have a reasonable basis to conclude that a recommendation or advice provided is in a retail customer's best interest under the care obligation, broker-dealers and APs must:

- understand the potential risks, rewards and costs associated with a product, investment strategy, account type or series of transactions;
- have a reasonable understanding of the specific retail investor's investment profile, which generally includes the retail investor's financial situation (including current income) and needs; investments; assets and debts; marital status; tax status; age; investment time horizon; liquidity needs; risk tolerance; investment experience; investment objectives and financial goals; and any other information the retail investor may disclose in connection with the recommendation or advice; and
- consider reasonably available alternatives that may be less expensive, less risky or less complex before making a recommendation.

In recent enforcement actions, exam findings and other guidance, the SEC and FINRA have focused on the care obligation as it relates to three main areas: (1) reasonably available alternatives; (2) recommendations regarding complex or risky products (including private placements); and (3) documentation. Each of these areas is discussed below with some practice points.

Reasonably available alternatives

As previously noted, the care obligation requires broker-dealers and their APs to evaluate 'reasonably available alternatives' to a proposed investment or investment strategy.[27] SEC staff has said that consideration of reasonably available alternatives should begin early in the process of formulating a recommendation.[28] Specifically, to satisfy the care obligation, firms should establish a reasonable process that their APs can follow that will help facilitate the identification and assessment of reasonably available alternatives. This process should be documented and require APs to: (1) first, consider a broad array of investments or investment strategies that are generally consistent with the retail investor's investment profile; and (2) secondly, narrow these investments to a smaller universe of potential investments or investment strategies as the analysis is more focused on meeting the best interest of a particular retail investor.[29]

With regard to (1), firms should provide written guidance to APs regarding the scope of alternatives that should be considered and the suitability of particular product offerings and strategies for different types of investors, with reference to relevant factors in the customer's investment profile. The scope of alternatives should be sufficient to enable APs to have a reasonable basis to believe that their recommendations or advice are in the retail investor's best interest.[30] For example, to help APs identify an appropriate universe of alternatives, firms could consider providing guidance on the types of investments and investment strategies APs should consider when recommending investments or investment strategies to achieve particular investment objectives (eg long-term growth, short-term savings, preservation of capital, tax advantage or exposure to a particular market segment). This guidance also should include specific factors and questions to consider in determining which options are in the best interest of a particular retail investor in light of their investment objective and investment profile. For example:

- Are there products or strategies that are only appropriate for investors with a high or moderately high-risk tolerance?
- Are there products or strategies that are not appropriate for investors with a short-term investment horizon?
- Does the retail customer have a high need for liquidity? (if yes, investments with longer time horizons and limited or no secondary market should be excluded).

The universe of particular product offerings and strategies identified should be sufficiently broad to identify all relevant products that are consistent with a customer's investment profile and objectives. For example, merely considering different share classes for a mutual fund would not be a sufficiently broad universe. Rather, in the staff's view, the evaluation should consider any investments and investment types that are reasonably available to customers through the firm and could be used to achieve the investor's investment objectives.[31]

With regard to (2), after identifying a universe of reasonably available alternatives that are consistent with a customer's investment profile and investment objectives, APs should conduct a comparative assessment of these alternatives in order to identify the investments or investment strategies that they reasonably believe are in the retail investor's best interest.[32] To facilitate this assessment, firms should provide written guidance to the APs regarding the factors they must consider in narrowing the universe of products and strategies, and the tools they must use in this assessment (eg does the firm provide a database that allows APs to filter and sort mutual funds based on objective factors such as whether the fund is large cap versus small cap, international versus domestic?). One critical factor for narrowing the universe is cost. APs should be required to consider costs and the availability of less expensive alternatives that could achieve a customer's investment objective. Where there are two products that have similar strategies and performance records (such as an exchange-traded fund [ETF] based on the S&P index and a mutual fund that is intended to track the S&P index, or different share classes of the same mutual fund), APs should recommend the less expensive product, considering all costs to the customer (ie not just commissions or transaction costs). Here, the regulators expect that firms will provide written guidance to their associated persons on how to evaluate costs and reasonably available alternatives when making recommendations.[33]

Where two products are substantially identical (except for cost), firms and APs should expect that the regulators will focus on recommendations to buy the more costly product. For example, if a less costly mutual fund share class is available for brokerage customers (because, eg, investment minimums have been waived), the SEC will expect firms and APs to be aware of the availability of the less costly share class and recommend it over more expensive share classes, all else being equal.[34] More generally, regulators will expect firms and APs to fully understand which share classes may be available to their brokerage customers at both the initial onboarding stage and on an ongoing basis.

Where two products are not substantially identical, other relevant factors to consider include potential benefits and risks as well as overall compatibility with the retail investor's investment profile. In addition to cost, the SEC staff has noted that firms and APs would need to understand the potential risks and rewards associated with reasonably available alternatives as part of having a reasonable basis to believe that a recommendation or advice is in the best interest of the retail investor. For example, when recommending an investment with a higher risk, APs should consider both cost and risk when assessing alternative investments. Similarly, when recommending an investment based on a particular feature (such as tax advantage), APs should consider whether any reasonably available alternatives offer similar special features or rewards but are less costly or risky.[35]

The reasonably available alternatives analysis may be particularly challenging for firms that offer complex products, such as derivatives and structured products, which may not have obvious alternatives. Nonetheless, SEC staff has confirmed that broker-dealers and their natural person APs are required to consider reasonably available alternatives, even for complex products.[36] The reasonably available alternatives analysis may also be difficult for firms with limited product menus. Although a limited product menu may be consistent with the care obligation, firms are expected to periodically consider whether the investment options they make available to their clients are sufficient to meet their clients' best interest.[37] A firm and its financial professionals cannot rely on a limited menu to justify recommending an investment or providing advice that does not satisfy the obligation to act in a retail investor's best interest.[38]

Complex or risky products (including private placements)

Another area of recent regulatory focus relates to complex or risky products, including private placements. Recommendations involving these products will be subject to heightened scrutiny by the regulators.[39] Pursuant to regulatory guidance, complex or risky products include, but are not limited to, inverse or leveraged exchange-traded products, investments traded on margin, derivatives, crypto asset securities, penny stocks, private placements, certain asset-backed securities, volatility-linked exchange-traded products and reverse-convertible notes.[40] Of these products, the regulators have provided targeted guidance for private placements. For example, in late 2023, FINRA issued Regulatory Notice 23-08, which provides guidance for member firms selling private placements and considerations related to the care obligation. For firms that offer complex or risky products (including private placements), there are a number of key takeaways and lessons for building an effective compliance programme.

First, the regulators expect that firms will apply heightened scrutiny and heightened procedures to these products.[41] This may include, for example, more targeted supervision and surveillance, additional training, diligence and documentation of recommendations.

- On diligence, the staff has stated that firms should consider developing procedures outlining the due diligence process for complex or risky financial products, to help ensure that these products are assessed by qualified and experienced firm personnel.[42]
- Similarly, on training, firms should consider establishing procedures requiring appropriate training and supervision to help ensure financial professionals understand the features, risks and costs of a complex financial product.[43]
- Regarding documentation, documentation supporting a recommendation of a complex or risky product should identify the reasonably available alternatives that were considered and explain why lower risk or less complex options could not achieve the same investment objectives.[44] In short, firms and financial advisers (FAs) should be able to support a conclusion that a particular complex or risky product is in a particular retail investor's best interest over less complex or risky alternatives.
- On supervision and surveillance, 'red flags' or situations that would require enhanced review include recommendations regarding a complex or illiquid product that are inconsistent with the retail customer's investment profile, exceed concentration limits specified in a firm's policies or comprise a sizable portion of a retail customer's liquid net worth or securities holdings.[45]

Second, where a recommendation involves a private placement or other complex product, firms should conduct more targeted due diligence, including reviewing the offering material. Firms should be able to show that they and their FAs did some level of diligence such that they understand the complex product (eg for leverage and inverse ETFs or derivatives, being able to explain how they work). In FINRA enforcement actions, the regulators identified as deficiencies failing to conduct a reasonable investigation of offerings prior to recommending them to retail customers (eg some firms were unable to reasonably evidence due diligence efforts regarding the issuer, relied solely on the firm's past experience and knowledge with an issuer based on previously completed offerings and/or failed to review the current offering material).[46] Consistent with guidance in FINRA Regulatory Notices 23-08 and 10-22, prior to recommending a private placement, a firm *must* conduct a reasonable investigation concerning the following areas, where relevant:

- the issuer and its management, the business prospects of the issuer, the assets held by or to be acquired by the issuer, the claims being made and the intended use of proceeds of the offering;
- regulatory and litigation history of the issuer and its management;
- new material developments, including events that are or should be reasonably known to the member during an offering;
- transactions or payments between an issuer and the issuer's affiliates involving offering proceeds; and
- representations of past performance of the issuer, its sponsor or its manager to identify any such representations that may be misleading or exclusively selected based on positive results.

A firm's independent analysis of the offering should not rely solely on representations made by the issuer or its affiliates. Instead, firms should conduct a 'reasonable investigation' of these statements, which may include: reviewing the offering terms to determine if they are reasonably structured for compliance with applicable rules; communicating directly with the issuer; applying a heightened analysis when recommending an investment that involves complex features or unique benefits to investors; and maintaining an updated due diligence file for serial issuers. FINRA has recently brought enforcement actions against member firms that did not independently verify certain statements made by issuers in private placement offering material or otherwise conduct due diligence on issuers' statements.[47] More specifically, FINRA alleged that the broker-dealers did not have a reasonable basis to believe the offerings were in the best interests of their customers in violation of the Care Obligation. Separate from the due diligence conducted by firms, APs recommending private placements should understand the security they are recommending, including risk factors and costs, and conduct their own assessment on whether a recommended private placement is in a particular retail customer's best interest.

Documentation of policies and procedures and recommendations

The SEC and FINRA have also provided guidance regarding the level of detail that must be documented in policies and procedures, as well as which recommendations should be documented. Based on this guidance, it is clear that firms' policies and procedures should not provide APs with wide discretion regarding the sources or factors that they should consider in fulfilling their Best Interest obligation. Rather, procedures should detail the factors that APs must consider, how to consider them, and which tools they should use to identify securities that are in the customer's best interest. For example, in an SEC risk alert on Reg BI, the staff outlined a number of common mistakes or deficiencies.[48] These areas include the following:

- policies and procedures that direct financial professionals to consider reasonably available alternatives without providing any guidance as to how to do so (eg by establishing the scope of alternatives to consider or systems to use for considering reasonably available alternatives in formulating a recommendation);
- policies and procedures that direct financial professionals to consider costs without providing any guidance as to how to do so (eg how to consider costs when making a recommendation, what types of costs to consider, including direct and indirect costs or what systems to use to analyse costs in formulating a recommendation);
- policies and procedures that do not mandate the use of firm systems allowing financial professionals to evaluate costs or reasonably available alternatives (or enable the firm to track APs' use of such systems);
- policies and procedures that direct financial professionals to document the basis for their recommendations but did not mandate when documentation is necessary.[49]

Regarding documentation of recommendations, the SEC has stated that there is no requirement to document every recommendation.[50] However, increasingly, the SEC staff have indicated an expectation that there will be documentation, for example, to establish that reasonably available alternatives were considered and promote supervision:

> 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.[51]

In light of these expectations, firms should consider providing clear guidelines of which situations require documentation and monitor that APs are, in fact, documenting their recommendations. For example, even if a product is not a complex product, firms may consider requiring documentation where a recommendation poses conflicts of interest for the firm or the AP.

Where firms use concentration reports to monitor that recommendations are consistent with investment profiles, the regulators will expect the reports to be appropriately calibrated to identify exceptions. For example, for investors with a low-risk or moderate-risk profile, alerts that identify only high concentration levels of complex, risky products may be viewed as not 'reasonably alerting supervisors' to investments that are not consistent with a customer's risk tolerance and investment profile.[52]

ARTIFICIAL INTELLIGENCE AND REG BI

Separate from the care obligation considerations detailed above, firms and compliance professionals will need to navigate how evolving technology (in particular, the use of artificial intelligence [AI]) will affect their compliance programmes. In its 2024 Regulatory Oversight Report, FINRA identified artificial intelligence as an 'emerging risk' in the broker-dealer industry.[53] FINRA specifically cautioned firms to focus on Reg BI when considering the use of AI (whether proprietary or third party AI). While there is no specific regulatory guidance on the use of AI in the Reg BI context, there are a number of considerations for firms as they navigate new technologies. As a threshold matter, firms should consider whether AI programs could be viewed as a recommendation to retail customers. For example, where a firm uses AI programs to identify investments or investment strategies that may meet a particular customer's investment profile and objectives, that program could be creating a 'recommendation' or 'investment advice'. Firms may also use AI to issue targeted research to customers, which again, could be a 'recommendation' depending on the context.[54] Firms that employ AI-based applications to help formulate recommendations or advice may consider reviewing their current framework in light of the following considerations.

At a minimum, if firms are using such AI-based models, these models should be subject to the same controls and quality management framework as other models used by firms, such as controls around model development, validation, deployment, ongoing testing, change management and output monitoring. In addition, the control framework should address the unique challenges that AI output may pose. These challenges may include those related to model explainability, enhanced quality control, data integrity, customer privacy and recordkeeping.

First, regarding model explainability, while some models provide transparency on the underlying assumptions and factors considered in making a conclusion, other models may be 'black boxes' because it may be difficult or impossible to explain how the model works (ie how its outcomes are generated). FINRA has suggested that firms should incorporate explainability as a key consideration in the model risk management process for AI-based applications.[55] This may involve, for example, requiring application developers and users to provide a written summary of the key input factors and the rationale attributed to the outputs.

Secondly, enhanced quality control may be required for AI-based outputs that carry heightened risk given their use (such as recommendations provided directly to customers), or present challenges for compliance because the rationale attributed to their outputs may be unknown (eg black box models). Applying additional controls around these models, including human review and human decision making over model outputs, will be important.

Thirdly, regarding data integrity, the quality of the AI output is only as good as the underlying data. Databases or datasets that AI programs use should be reviewed for completeness and accuracy. Where a dataset is too narrow or skewed to a particular outcome (eg favouring a particular market segment or product category), this could lead to data bias and skewed results. At the same time, incorporating data from many different sources may introduce new risks by adding complexity; data from multiple sources will need to be validated (both on an initial and ongoing basis) for accuracy and staleness. Firms should be particularly sensitive to conflicts of interest that may be embedded in the datasets or AI models. For example, are proprietary products or products with revenue share arrangements prioritised over other products?

Fourthly, firms should be aware of customer privacy concerns. To the extent datasets or AI models involve collection and use of personally identifiable information (PII), this information should be safeguarded and handled in accordance with the firm's privacy policies and federal and state privacy regulation. Similarly, to the extent AI applications track and monitor customer trading, behaviour and preferences, they may also implicate privacy issues, and this information should be handled with care.

Fifthly, firms that rely on third party vendors and outsource AI-based programs should consider the relevance of FINRA's outsourcing guidance. Even where activities or functions are outsourced to a third party, firms are still required to ensure that the third party is performing the outsourced functions in accordance with applicable securities laws and regulations.[56] This means, among other things, that firms should require vendors to apply the same safeguards to PII that they apply and also apply data quality and model integrity standards to avoid introducing bias or conflicts of interest.

Finally, firms should be aware of books and records obligations that may apply to different uses of AI. For example, AI tools that result in internal or external written or electronic communications (eg through bots or other tools) may require firms to comply with recordkeeping requirements under SEC and FINRA rules.

CONCLUSION

Over the past year, the SEC and FINRA have significantly increased their enforcement efforts, with a particular focus on the care obligation of Reg BI. At the same time, both the SEC and FINRA have been prolific in publishing detailed guidance on applicable regulatory requirements, best practices and common deficiencies. This paper has detailed the key lessons from enforcement actions and published guidance, which will be crucial for firms and compliance professionals to consider as they work to maintain an effective and up-to-date compliance programme to satisfy the care obligation. Separately, to the extent firms are considering the use of AI to facilitate their ability to provide recommendations or advice to customers, there are additional issues to consider. While the introduction of AI presents opportunities to provide enhanced customer service when recommending a security or investment strategy involving a security, it also raises new risks and regulatory issues.

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(6) Reg BI Adopting Release, ref 1 above, 84 Fed. Reg. at 33463.
(7) *Ibid*. at 33463.
(8) 17 C.F.R. § 240.15l-1.
(9) Under Reg BI's general obligation, a broker-dealer and its APs, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, must act in the best interest of the customer at the time the recommendation is made, without placing the financial or other interest of the AP or broker-dealer ahead of the interests of the customer.
(10) 17 C.F.R. § 240.15l-1(b)(1).
(11) Reg BI Adopting Release, ref 1 above, 84 Fed. Reg. at 33339 n. 202.
(12) *Ibid*., at 33342.
(13) Care Obligation Bulletin, ref 5 above.
(14) See Securities and Exchange Commission (23rd December, 2020) 'No-Action Letter from Emily Westerberg Russell, SEC Chief Counsel, to Stephanie Nicolas, WilmerHale', available at https://www.sec.gov/divisions/marketreg/mr-noaction/2020/sifma-122320-regbi.pdf (accessed 12th September, 2024).
(15) Reg BI Adopting Release, ref 1 above, 84 Fed. Reg. at 33335.
(16) *Ibid*.
(17) *Ibid*.
(18) *Ibid*.
(19) *Ibid*.
(20) Securities and Exchange Commission (30th March, 2022) 'Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors', available at https://www.sec.gov/tm/iabd-staff-bulletin (accessed 12th September, 2024) ('Account Recommendations Bulletin').
(21) *Ibid*.
(22) 17 CFR § 240.15l-1(a)(2)(ii).
(23) 17 CFR § 240.15l-1(a)(2)(ii)(A).
(24) Reg BI Adopting Release, 84 Fed. Reg. at 33377 (emphasis added).
(25) 17 CFR § 240.15l-1(a)(2)(ii)(B).
(26) 17 CFR § 240.15l-1(a)(2)(ii)(C).
(27) Care Obligation Bulletin, ref 5 above.
(28) *Ibid*.
(29) *Ibid*.
(30) *Ibid*. Where a firm has an 'open architecture' offering, financial professionals do not need to be familiar with every available investment; however, there should still be an objective process to evaluate a range of potential alternatives that would satisfy the customer's investment profile.
(31) *Ibid*.
(32) *Ibid*.
(33) See Financial Industry Regulatory Authority (2024) 'Annual Regulatory Oversight Report: Reg BI and Form CRS', available at https://www.finra.org/rules-guidance/guidance/reports/2024-finra-annual-regulatory-oversight-report/reg-bi-form-crs (accessed 12th September, 2024) ('2024 FINRA Annual Report').
(34) Securities and Exchange Commission (16th February, 2024) Exchange Act Release No. 99549.
(35) Care Obligation Bulletin, ref 5 above.
(36) *Ibid*.
(37) *Ibid*.
(38) *Ibid*.
(39) *Ibid*.
(40) *Ibid*. To be clear, not all complex products should be considered 'risky' products, and some, in fact, may reduce risk. There is currently no standard definition of a 'complex product'. In Regulatory Notice 12-03, FINRA described characteristics that could make a product 'complex'. These characteristics may include, for example, features that may make it difficult for a retail investor to understand the essential characteristics of the product and its risks (eg the payout structure and how the product may perform in different market and economic conditions). A product that combines features of multiple products and strategies also may be considered complex (eg leveraged or inverse exchange-traded products that can employ futures contracts and other derivatives or may engage in short sales; structured products with embedded optionality; interval funds; non-traded real estate investment trusts).
(41) 2024 FINRA Annual Report, ref 33 above.
(42) Care Obligation Bulletin, ref 5 above.
(43) *Ibid*.

(44) *Ibid*.
(45) *Ibid*.
(46) Financial Industry Regulatory Authority (11th May, 2023) 'Letter of Acceptance, Waiver, and Consent No. 2020065599101'. The letter finds (i) that the firm failed to confirm that the issuer of certain pre-IPO private placements 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; and (ii) that the firm wilfully violated the disclosure obligation when it made material misrepresentations and omissions to investors in connection with the offerings); Financial Industry Regulatory Authority (19th May, 2023) 'Letter of Acceptance, Waiver, and Consent No. 2021069277101'. The letter finds that the firm failed to establish an adequate supervisory system for its recommendations of private placements.
(47) Financial Industry Regulatory Authority (13th November, 2023) 'Letter of Acceptance, Waiver and Consent No. 2019061852801'; Financial Industry Regulatory Authority (11th May, 2023) 'Letter of Acceptance, Waiver and Consent No. 2020065599101'.
(48) Securities and Exchange Commission, Division of Examinations (January 2023) 'Risk Alert: Observations from Broker-Dealer Examinations Related to Regulation Best Interest', available at https://www.sec.gov/file/exams-reg-bi-alert-13023.pdf (accessed 12th September, 2024).
(49) *Ibid*.
(50) *Ibid*.
(51) *Ibid*.
(52) Financial Industry Regulatory Authority (27th December, 2023) 'Letter of Acceptance, Waiver and Consent No. 2017052494701'.
(53) Financial Industry Regulatory Authority (2024) '2024 FINRA Annual Regulatory Oversight Report', available at https://www.finra.org/sites/default/files/2024-01/2024-annual-regulatory-oversight-report.pdf (accessed 12th September, 2024).
(54) See Financial Industry Regulatory Authority (n.d.) 'Guidance Regarding AI Applications in the Securities Industry', available at https://www.finra.org/rules-guidance/key-topics/fintech/report/artificial-intelligence-in-the-securities-industry/key-challenges (accessed 12th September, 2024).
(55) *Ibid*.
(56) See Financial Industry Regulatory Authority (13th August, 2021) 'Regulatory Notice 21-29: FINRA Reminds Firms of their Supervisory Obligations Related to Outsourcing to Third-Party Vendors', available at https://www.finra.org/rules-guidance/notices/21-29 (accessed 12th September, 2024).