

Insights into the States' 2021 BD Examination, Enforcement Priorities

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Putting Teeth on Reg BI (to take a bite out of complex products sales), Protecting Seniors (from romance scams, affinity frauds, and rogue POAs), Scrutinizing Bank-Based Reps, DBAs, and Remote Supervision, and the beginning of the end of COVID-Regulatory Relief

The implementation date for Regulation Best Interest ("BI") has come and gone, and as the leaders of the U.S. Securities and Exchange Commission ("SEC") have been installed by the new Biden administration, the new SEC's priorities have emerged: ESG, SPACs and crypto, plus trading and market integrity (speedier settlement, more transparency in swaps and short selling, parsing where free speech ends and manipulation begins in an AI- and social-media driven world, etc.).

Meanwhile, the seasoned staffs of the state securities departments around the country – many continuing long tenures in their roles – remain steadfastly focused on their evergreen priority: protecting the "mom and pop" and the "tik tok" retail investors.¹ For many, their tools for examinations and enforcement have been sharpened, their methods honed and increasingly automated and coordinated, but their mandate remains the same as it's always been.

The goal of this alert is to provide information and areas of consideration for compliance and legal personnel (generally referred to herein as "practitioners") who are tasked with ensuring that a broker-dealer ("BD") and its registered representatives ("RRs") comply with the laws, rules and regulations in each state where they do business,² in light of emerging regulatory interpretations by those states.³

Background

The offer and sale of securities by BDs and RRs are regulated by, among others, the SEC, the Financial Industry Regulatory Authority ("FINRA"), and state securities administrators (and their staffs) in each of the 50 U.S. states, the District of Columbia, Puerto Rico and the Virgin Islands (collectively referred to herein as the "States"). Among these three, only the States are singularly focused upon sales practices impacting Main Street retail investors.

BDs (of all shapes and sizes) ignore the States' regulatory priorities at their peril. Over the years, individual states, and States acting in concert with each other, have brought significant enforcement actions, levied large fines, imposed costly remediations, and regularly make enforcement referrals or queue up enforcement actions to FINRA, the SEC, and private litigants.

The North American Securities Administrators Association ("NASAA") enables the States (a.k.a. its members) to coordinate on investor protection initiatives by: promulgating model rules, lobbying Congress and federal administrative agencies (e.g., the SEC and Department of Labor), offering investor and industry education, and by detecting, deterring, and punishing fraud and abuse.

While NASAA does not have any legal authority – each member jurisdiction must take action consistent with that state's laws and regulations – NASAA has proven a powerful and useful mechanism for aggregating and leveraging the limited resources available within any single jurisdiction. These efforts are effected through NASAA standing sections, project groups, and task forces.⁴

This alert describes certain current (2021) areas of focus for the States based upon various publications (as referenced in the endnotes) and conversations with the States, including members of the NASAA BD Section and the NASAA Regulation Best Interest Implementation Committee (hereafter, the "Committee"). Nothing herein is intended to suggest that the States are monolithic; references to the States collectively (including positions or opinions attributed to "the States") are made in that manner for editorial and reader ease. The priorities and programs in any state almost certainly vary from those of another state. Notwithstanding, the issues outlined below are known priorities in a number of states with active, engaged securities regulatory regimes. These are recurring, common themes that we believe warrant serious consideration by practitioners, some with 2021 twists.

A. Putting Teeth on Reg BI and Taking a Bite out of Complex Products Sales

In the Reg BI rulemaking process, NASAA advocated for the application of a new BD standard of conduct akin to a fiduciary duty.⁵ The final rule, as well as Form CRS, lacked many of the elements NASAA recommended in its comment letters. While SEC Chairman Gensler has directed SEC staff to seek comment and provide guidance as to Reg BI's application to bespoke issues (such as trading apps),⁶ there is no indication that a broad overhaul of Reg BI will be undertaken. Accordingly, the States have been left to do what some discussed in September 2019 at the NASAA Annual Conference: build an examination and enforcement regime around Reg BI that is intended to ensure the most stringent interpretation of its requirements. Early indications suggest that the States' expectations for BDs are higher than the SEC's expectations (as articulated in Reg BI's adopting release, subsequent FAQs, and alerts and priorities published by the Division of Examinations).⁷

1. Reg BI Survey, Phase One, 2020

In Q1 2020, the Committee conducted Phase One of its Reg BI national examination initiative (the "Reg BI Survey"). To identify a baseline of pre-Reg BI policies, procedures and sales practices, Phase One surveyed⁸ 516 BDs (15 percent of FINRA member firms)⁹ in 34 States.¹⁰ Phase One also surveyed 1,522, mostly state-registered, investment advisers ("IAs"), to identify practical differences between those subject to a fiduciary duty (the IAs) versus those subject to a suitability standard (the BDs pre-Reg BI). Among other things, we expect that when the States conduct Phase Two of the survey this summer, they will look to see whether the BDs have moved closer to where IAs were in the Phase One survey results. (IAs will not be included in Phase Two.)

In September 2020, the Committee released a report of its Phase One findings¹¹ and described or alluded to other ways that BD practices will (per the Committee) likely need to change to comply with Reg BI, including:

- Requiring that RRs disclose to customers at the point of sale:
 - whether there is lower-cost/less complex/more liquid product available (whether on or off the firm's platform) that would meet the customer's investment objective;
 - the cost (including fees, commissions etc.) associated with a recommended securities transaction, rollover or type of account opening;
- Enhancing firms' know-your-customer questionnaires to include, among other things, questions about the customer's education level and personal/household debt;
- Changing disclosure and conflicts mitigation relative to sales contests, quotas or bonuses, third-party compensation from another BD, IA or financial institution; and third-party compensation from product manufacturers (between 15 and 18 percent of BDs surveyed reported having one or more of these conflicts);
- Implementing a conflict of interest register and/or conflicts of interest committee or designated officer;¹²
- Address titling concerns;
 - 40 percent of BDs surveyed allowed their RRs to use the title of *advisor* or *adviser* in marketing materials, disclosures, customer agreements, websites, on business cards or on social media while operating in the capacity of a BD's RR (not as an IA);¹³

- 32 percent of BDs that allowed RRs to use the title had no prerequisite for the RRs' use of that title (e.g., requiring the RR to be dually registered as both an RR and IA representative).¹⁴
- Obtaining error and omission ("E&O") insurance coverage for investor losses.
 - 38 percent of BDs surveyed did not have E&O insurance to cover investor losses.¹⁵
 - 93 percent of those with coverage did extend that coverage to all of their registered persons.¹⁶

2. Reg BI Survey, Phase Two & Examinations, 2021

The Committee plans to conduct Phase Two of the Reg BI Survey this summer, and also expects that the States will begin to conduct Reg BI examinations (both remotely, and onsite); those exams may include the Reg BI Survey or occur independent of the Reg BI Survey. It appears that originally, the Committee planned to gather the Phase Two survey results and then roll-out the Reg BI examination modules to the States – more on modules below – but as we all know by now, the pandemic often wreaks havoc on the best-laid plans.

Phase Two will largely seek to identify what changes, if any, BDs have made in their sales practices, especially with respect to four product types: (1) private placements, (2) variable annuities ("VAs"), (3) non-traded REITs and other direct participation programs ("DPPs") and (4) leveraged- or inverse exchange traded funds ("ETFs") (collectively, "Complex Products"). Notably, 64 percent of firms surveyed (both BDs and IAs) did not make any of these products available to their customers.¹⁷ The Committee found that in 2020, 26 percent of BDs surveyed offered private placements, 49 percent offered VAs, 27 percent offered non-traded DPPs, and 25 percent offered leveraged- or inverse-ETFs.¹⁸

a. Modules Designed to Provide for Consistent, Uniform, Scalable Reg BI Examinations

In November 2019, NASAA launched its significantly enhanced electronic examinations module interface ("NEMO"), which is a web-based software application designed to assist the States in conducting examinations of BDs (and state-registered IAs) in a secure, digital environment.¹⁹ NEMO allows NASAA to more quickly identify trends and plan policy initiatives, or enforcement task forces based upon statistical reporting of data aggregated across all participating jurisdictions.²⁰

It is our understanding that: The Committee and NASAA have designed four NEMO modules, one specific to each of the Complex Products.²¹ In crafting these modules, NASAA sought to design thorough, detailed exam materials that can be scaled (*i.e.*, downsized or right-sized) by a state, so that one or more Complex Products' exam(s) can be integrated into a broader exam or stand alone. This approach will hopefully ease the burden on BDs operating in numerous jurisdictions by ensuring consistency and uniformity in questions and setting clear expectations. We understand that NASAA will also make available to its members additional Regulation BI examination materials (beyond the Complex Product-specific modules). While these materials may be updated from time to time, the expectation is that these will generally form the basis for the States' Reg BI examinations going forward.²²

b. The States' Perspective on Reg BI Compliance in the Sale of Complex Products

Context

When the States describe what compliance with Reg BI should look like, in the context of BDs/RRs offering and selling Complex Products, it is often presented from the perspective of a hypothetical, unsophisticated (perhaps: busy, distracted, or overly trusting) retail investor. (*i.e.*, what might he or she focus on, expect, understand, or presume in a conversation with the RR assigned to handle his or her brokerage account?). In contrast, when practitioners set out to design a supervisory system to ensure compliance with a rule (like Reg BI) they tend to consider whether compliance measures are operationally-feasible (*i.e.*, can the measure be standardized, and is it scalable and surveillable by an automated system?).

Given their respective experiences, roles, responsibilities, and vantage points, each approach is reasonable but sometimes difficult to reconcile. This difficulty is perhaps most stark when it comes to the Complex Products; it is fair to say that many regulators, including many in the States, tend to be dubious that a solicited brokerage sale of a Complex Product to a retail investor is ever in that customer's best interest. Obviously, many industry participants would strongly disagree.

Perspective

The following describes our understanding of some of the States' expectations and concerns, as well as some worthwhile considerations for practitioners relative to the offer and sale of Complex Products by BDs to retail investors under the best interest standard:

1) Private Placements

Expectations

- In Phase Two, it appears that the States expect BDs to have revised their procedures to require conspicuous, point of sale disclosure of fees (including, but not limited to, the commission payable to the RR as either a dollar amount or a transaction-based percentage). States will likely be dissatisfied that an offering document (such as a private placement memorandum or operating agreement) that included, somewhere within the document, a reference to the fees was provided to an accredited investor at some point before the sale was consummated.

Concerns

- A decade of low interest rates, leading to low returns in savings accounts and other FDIC-insured products, has arguably played a role in encouraging RRs and their investors further out onto the risk curve in pursuit of yield that is independent of the stock market, which is viewed by many as overvalued and unmoored from fundamentals. Also, former SEC Chairman Clayton and certain members of Congress advocated for (including introducing legislation,²³ and supporting rulemakings²⁴ aimed at) expanding access by retail investors to private offerings.²⁵ Whereas, NASAA has consistently urged caution in expanding private offerings and access thereto, and in January 2021 penned a letter (co-signed by other investor protection organizations) urging the Biden Administration to curtail any further growth of the private securities sector and instead work to reinvestigate the public markets.²⁶
- Investors may be enticed by the promise of high returns and the lure of investments available only to "accredited investors" without truly appreciating the full sum of fees associated with the investment, or the potential real-life implications that can result from the lack of a secondary market and corresponding illiquidity of the investment.

Considerations

- Practitioners may find it helpful to include in annual supervisory reviews or surveillance exception reporting a review of product concentrations across an RR's customers' accounts in an effort to identify patterns indicative of recommendations based upon factors other than each customer's individual investment profile.
- Practitioners may find it helpful to implement training and testing for RRs regarding how to read and glean the material details from product prospectuses to ensure an RR is capable of fully understanding the structure of the offering (*e.g.*, the rights and obligations of a limited partner), how the investment operates during the holding period (*e.g.*, whether there are capital calls, side pockets, etc.) and the full extent of possible fees (including, but not limited to, the commissions payable to the RR).
- There are many types of BDs, including BDs that exist primarily or exclusively to serve as private placement agents for issuers. These BDs typically do not have customer accounts (the investment contracts are directly between the issuer and the purchaser), and their contractual customer agreements are with the issuers, not the purchasers. How best to interpret and apply the obligations of Reg BI to these firms seems to remain an open question with the States. These firms should consider whether their communications to prospective purchasers make clear that they are acting on behalf of the issuer(s) (not the purchasers), they are offering only one type of product (private placements), and that a well-balanced investment portfolio almost certainly includes other or additional securities not offered by that BD.

2) Variable Annuities

Expectations

- VAs are a hybrid product (part investment product and part insurance product) that come in myriad varieties and amalgamations. There seems to be an acknowledgement that it may be particularly difficult for BDs/RRs to explain why the product sold was better than other available VAs.
- Regulatory scrutiny may be tempered with some allowance for BDs/RRs to undertake a two-fold analysis that acknowledges that VAs are arguably inferior to other securities solely as an investment product but that the insurance-elements that generate the increased cost also, theoretically, provide additional benefits that may be unavailable/not recreateable (at least not by an RR in a brokerage account) with securities alone.
- The States with jurisdiction over VA sales by BDs may look for evidence that the RR:
 - carefully considered the mutual fund(s) that compose the variable aspect of the annuity and the purpose of the insurance riders included within the VA that was sold;
 - disclosed that "principal protection" or "guaranteed income" came at a high-cost to the investor; and
 - disclosed to the investor that historically a buy-and-hold strategy in a well-balanced portfolio over a holding period akin to the VA's lock up period would have resulted in a higher return on investment than the return provided for in the VA.
- It will be particularly difficult to evidence compliance with the best interest standard when an RR recommended a VA switch that triggered surrender charges on the prior product, in addition to costs associated with the new product.

Concerns

- The States are nearly universally suspicious of VAs in light of the expenses (including high commissions, and surrender charges), protracted lock-up periods, and historically problematic sales practices (e.g., free lunch seminars marketed at senior and assisted-living centers, frequent switches during surrender periods, use of fear tactics like an impending catastrophic market crash).
- VAs generally pay high commissions (either in an upfront lump sum, in trailing commissions, or a combination of both); even if a customer's investment goals (for principal protection and income) can be achieved through a well-balanced portfolio of securities (instead of a VA), it is understandable that RRs would resist doing more work for less compensation.

Considerations

- Unlike the other three Complex Products, VAs are subject to highly disparate regulatory treatment from one state to another. In many states, VAs are insurance products outside the jurisdiction of the state's securities administrator.²⁷ (However, States sometimes assert jurisdiction over the sale of a VA when the source of funds used to purchase the VA was derived from the sale of a security.)
- FINRA Rule 2230 prescribes product-specific requirements for the offer and sale of VAs by BDs and their RRs.
- As a pure financial matter, a typical VA is most likely only in the money if there is a catastrophic market event. In those instances, for a VA to be in a customer's best interest, the customer would need to value the insurance policy's income guarantees more than she values investment returns.
- The relatively high commissions paid to RRs on VAs may make it difficult for a BD to explain why the customer's objective of income could not be achieved through a less costly alternative product (or combination of products). For dual registrants, insurance sponsors now offer so-called "fee only" VAs whereby there is no sales commission paid to the representative; instead the IA charges its standard management fee relative to the assets invested in the VA (and may also receive a modest marketing reimbursement from the issuer).²⁸

3) Non-Traded REITs (and other DPPs)

Expectations

- In Phase Two, it appears that the States expect BDs to have revised their procedures to require that their RRs prepare (and the BDs retain) proof that the RRs considered the cost associated with a recommendation and reasonably available alternative products, and determined that the recommended product was the best product for the customer's need.
- Specifically, written proof in the form of a client-specific (not cookie-cutter, or token) analytical explanation that explains why an unlisted, non-traded REIT (instead of a publicly-traded REIT or other product) was appropriate to meet the customer's objectives.
- E.g., an RR who sold the same non-traded REIT to several customers would likely not meet the States' expectations for compliance if every record concluded that the product was in each customer's best interest because "Customer wants non-market correlated real estate exposure." This explanation fails to describe (1) the RR's analysis of the non-traded REIT's costs, (2) the alternative products considered (e.g., a public REIT), and (3) the RR's basis for concluding that the non-traded REIT sold was in the customer's best interest.

Concerns

- States seem to view these products as suitable only for highly-educated, experienced investors, who are looking to further diversify a small percentage of their overall investment portfolio.
- Non-traded REITs have been an area of focus for FINRA and the States for many years. FINRA has product-specific rules regarding account statement valuation²⁹ for DPPs and non-traded REITs. The States have substantive registration authority over the product, and many states condition the security's registration in the state upon inclusion in the prospectus of heightened suitability requirements (e.g., minimum liquid net worth and maximum concentration limits – i.e., limits on how much of a person's worth can be invested in non-traded REITs and other DPPs).

Considerations

Given the steps involved in ensuring adherence to state-specific heightened suitability standards included in the prospectus as offering restrictions, some RRs may be surprised (or frustrated) to learn that Reg BI requires additional diligence and analysis relative to the product's cost and alternatives.

Fulsome consideration of alternatives likely includes considering other types of the same product (i.e., non-traded REITs offered by a range of sponsors), and other products that might offer the same type of industry exposure without the costs, valuation challenges, or illiquidity of a non-traded REIT (e.g., a publically-traded REIT or an ETF with exposure to a certain real estate segment).

4) Leveraged, Inverse ETFs

Expectations

- In Phase Two, the States seem to expect that BDs will have implemented policies and procedures that:

- prohibit RRs from soliciting the sale of a leveraged or inverse ETFs in a brokerage account;
- for dual-registrants, allow the use of the product only in advisory accounts (specifically, the managed accounts of sophisticated, aggressive IA clients).

Concerns

- Leveraged and inverse ETFs were a focus for the States and FINRA well before Reg BI. These securities (per their prospectuses) are intended for day trading, and require close, ongoing monitoring within an account. Arguably, a relatively high account size is needed to comfortably absorb the costs associated with the turnover inherent in day-trading. As such, it was difficult for RRs to meet FINRA's suitability standard for these products.³⁰ (They also pose tremendous risk for BDs, as customers can quickly take on enormous losses.)

Considerations

As a risk mitigation measure, practitioners may consider whether it would be helpful to provide conspicuous, point of sale disclosure relative to unsolicited trades placed by BD customers for their own account in leveraged or inverse ETFs, or whether it may be prudent to remove leveraged or inverse ETFs entirely from the available products on their platforms.

B. Protecting Seniors and other Vulnerable Adults

Background

In 2014, NASAA formed a Board-level committee and launched a website (serveourseniors.org) dedicated to senior issues. It also reported in that year that at least one-third of the States' enforcement actions involved senior investors. In February 2016, NASAA distributed to its members a model act entitled, "*An Act to Protect Vulnerable Adults from Financial Exploitation*" (the "Model Act"). In September 2016, the BD Section released a report describing coordinated examination findings on issues related to seniors.³¹ Senior investor protection has remained a top priority for the States ever since.

The Model Act sought to coordinate efforts by securities regulators, investment advisers, BDs and state adult protective services ("APS") agencies to detect and prevent financial exploitation of vulnerable adults.

The Model Act generally has the following provisions:

- **Mandatory reporting.** The Model Act mandates reporting to the appropriate state securities regulator and APS agency when the firm (including through an employee or FA) has a reasonable belief that financial exploitation of an eligible adult has been attempted or has occurred.
- **Client and trusted contact notification.** The Model Act authorizes notification to third parties (*i.e.*, non-clients) only in instances where an eligible adult has previously designated the third party to whom the disclosure may be made. Importantly, the Model Act directs that disclosure may not be made to the third party if the third party is a suspected perpetrator of the financial exploitation.
- **Asset holds.** The Model Act enables firms to impose an initial delay of disbursements from an account of an eligible adult for up to 15 business days if financial exploitation is suspected. The delay can be extended for an additional 10 days at the request of either the state securities regulator or APS.
 - The asset hold provision includes:
 - Safe harbor language that provides immunity from administrative or civil liability for BDs and IAs for taking certain actions, including delaying disbursements as permitted under the Model Act.
 - A requirement to conduct an internal review of the suspected exploitation that formed the basis of implementing the hold and to notify both APS and the commissioner of securities of the hold within two days.
- **Recordkeeping requirements.** The Model Act requires firms to provide records that are relevant to the suspected or attempted financial exploitation to government authorities upon request.

Model Act States. According to the NASAA website, as of 2021, the following jurisdictions have enacted legislation or regulations based upon the Model Act: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Delaware, Florida, Indiana, Kentucky, Louisiana, Maine, Maryland, Minnesota, Mississippi, Montana, New Hampshire, New Jersey, New Mexico, North Dakota, Oregon, Rhode Island, Tennessee, Texas, Utah, Vermont, Virginia, and West Virginia. Notably, while these states' legislation and regulations are based on the Model Act, they do not all perfectly mirror the Model Act.

Non-Model Act States. According to the NASAA website, as of 2021, the following jurisdictions have enacted legislation or regulation relating to senior financial exploitation that is not based upon the Model Act (often because these states' laws preceded the Model Act): Connecticut, DC, Georgia, Hawaii, Idaho, Illinois, Iowa, Kansas, Massachusetts, Michigan, Missouri, Nebraska, Nevada, Nebraska, Nevada, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Puerto Rico, South Carolina, South Dakota, Washington, Wisconsin, and Wyoming.

Generally speaking, the non-Model Act states tend to address only reporting to APS and sometimes training requirements, whereas the Model Act states typically also include asset hold safe harbors and requirements to report asset holds to state securities regulators. Importantly, each jurisdiction's requirements vary. For example, Washington is a non-Model Act state that nonetheless has an asset hold provision. In addition, the definitions that define the scope of each state's act, such as who is a vulnerable adult or whether a hold can be placed on a securities transaction (versus a disbursement), often differ from one state to another, regardless of whether the state is a Model Act state or a non-Model Act state.

1. What's New in Senior Investor Protection?

In 2019 (the last year for which summary data is available), the States fielded 709 reports, opened 233 investigations and brought 15 enforcement actions relating to reports made under the Model Act.³² More broadly, the States conducted 486 investigations, and brought 208 enforcement actions, relative to 857 senior investor victims.³³ Of those, 22 of the investigations related to variable annuities, 160 related to traditional securities, and 51 involved "affinity fraud." Affinity frauds target particular communities or groups, often a religious or ethnic group of which the fraudster is also a member, and operate by exploiting a sense of communal trust.

Anecdotally, in 2021, as society begins to emerge from the pandemic, several States have described a noticeable, and somewhat unexpected uptick in complaints (as compared to 2020). This is unusual insofar as an increase in customer complaints is rarely seen when the stock market is performing well. It may be that the isolation so many people have endured over the last year during the pandemic – especially seniors – has left them particularly vulnerable to various scams and frauds (including romance and precious metals scams) and now that families are getting back together, exploitation that took root during the pandemic is coming to light.

Considerations

Practitioners should consider whether any of the following would enhance their firm's senior investor protection regime:

- Design (or enhance) and implement policies, procedures and training, to enable RRs to quickly identify, escalate, report and curtail potential financial exploitation of a senior or vulnerable adult.
- Train RRs and other BD-associated persons who have contact with customers to:
 - understand and differentiate between terms like "exploitation" and "capacity";
 - understand what types of customer information can be shared with whom;
 - understand that fraud and exploitation are not purely the purview of strangers; a child, spouse, sibling, friend, neighbor, trustee, RR, or person acting with the senior's durable or springing power of attorney is also capable of exerting undue influence or obtaining unlawful control to deprive a senior of his or her assets.

- Routinely encourage all RRs to work with their customers to add a trusted contact to their accounts.³⁴
- Routinely remind RRs of the importance of fully understanding all aspects of any trust or power of attorney documents provided to the RR/BD by a customer.
 - It is important the RR understand the scope and application of these legal documents while the client still has sufficient mental capacity to correct any ambiguity or deficiency in the documents.
- Design a system for identifying and addressing mental incapacity or deterioration by RRs (*i.e.*, when it is the RR, not the customer, who has a rapid onset of dementia or other mental incapacity).

C. Bank-Based RRs and RRs Doing Business Under a Name Different than their BD

1. Doing Business As (“DBAs”)

Many RRs conduct their securities business using a name that is different than the name of the BD that holds their securities licenses and is responsible for their supervision. The States and practitioners often use the short-hand of “DBAs” to discuss these arrangements. DBAs are an area of concern for regulators because they can create supervisory challenges for BDs and confusion for customers.

Shakespeare’s Juliet famously wondered “What is in a name? A rose by any other name would smell as sweet.” The sentiment holds true here insofar as what a person (or business) is called does not alter its fundamental, intrinsic characteristics for better or worse. But, just as Romeo’s sur name was a label that distinguished his family from their rivals and conjured innumerable presumptions and expectations among the people of Verona, the name under which a business operates can have real implications for its customers. Switching metaphors: A wolf in sheep’s clothing, is indeed still a wolf, but its clothing can cause tremendous confusion and may be a predicate to great harm for any bamboozled sheep.

To be clear, most DBAs are not wolves (nor sheep). Many RRs are actively involved in their communities, and operate dynamic small businesses that offer a range of important services aimed at ensuring the financial well-being of their clients and fellow community members. These small businesses often have names that are meaningful to the business owner and to the community it serves. The good will inherent in that business’s name was earned and is a valuable asset.

As is true in so many things, the answer to reconciling business interests and regulatory concerns about investor confusion likely lies in clear communication (*i.e.*, disclosure) that respects an RR’s interest in leveraging their business’s name and sustaining their client relationships, without concealing, disguising (*e.g.*, in very small print on the bottom of a business card or webpage) or diminishing the identity and critical role of the registered BD that carries the RR’s license and the customer’s accounts.

The States bottom-line appears to be this: BD customers need to know the name of their BD, and understand the role the BD plays in executing their securities transactions, valuing and custodializing their assets, supervising the conduct of their RR, and handling their concerns and complaints, should any arise. States describe it as a red flag when a customer has never heard of and cannot identify the name of the BD that holds their RR’s brokerage license.

FINRA and the States have long scrutinized and expressed concerns about customer confusion that can result from DBAs.³⁵ There seems to be some discussion of whether a model rule, or at least specific guidance from NASAA or the BD Section aimed at defining disclosure requirements or best practices for DBAs, might prove useful.

2. Bank-Based RRs

DBA concerns are closely linked to another persistent regulatory concern: the sales practices of RRs that are (or soon will be, when everyone goes back into “the office”) physically located within bank and credit union branches (“bank-based RRs”). The concerns are two-fold: (1) that a customer may transfer their feelings of good will and trust for their bank or credit union (where they may have been a customer for decades) to an RR who is not employed by the bank, and is trying to sell securities in the hope of earning a selling commission;³⁶ and (2) given the now-prolonged low interest rates offered on savings accounts, customers are increasingly likely to use funds derived from a maturing FDIC-insured product or an FDIC-insured bank account to purchase securities.³⁷

In the bank-based context, certain States have specific rules relating to bank-based RRs, including the degree of disclosure required.³⁸ FINRA’s more generalized guidance on communications with the public, and Reg BI’s requirements relative to conflicts and disclosure, are also instructive in this space.

3. Bank-Based and DBA-related Considerations

Practitioners may find it helpful to offer (or require) training for RRs that are operating in an environment that may create confusion for customers about the responsibilities and/or affiliation of their RR and the BD that carries their RR’s license/holds their accounts. Practitioners may be able to help RRs understand the importance of clear communications – whether verbal or non-verbal (*e.g.*, wearing a polo shirt embroidered with the bank’s logo or placing SIPC signage next to FDIC signage) – and the relative ease of having plain English conversations with their customers about the BD’s role. These conversations need not be overly technical or in any way diminish the strength of the relationship and role of the RR in the provision of financial services to the customer.

D. Remote Supervision

BDs have extraordinary responsibility for supervising the conduct of their RRs. These obligations are set out in FINRA Rule 3110 and also in the States’ laws, rules, and regulations.

Even before the pandemic, many RRs were supervised by a person that was not physically located in the same location as the RR. Then, as a result of the pandemic, many (perhaps most) RRs began to work from home. Throughout the pandemic, FINRA and other regulators offered guidance and directives regarding remote supervision.³⁹ It now appears that the pandemic may have permanently altered many RRs’ working arrangements such that, going forward, a large segment of RRs may primarily work from home, physically removed from their supervisor(s).

We expect that States may conduct examinations regarding remote supervision, either as a part of a firm’s permanent business model or during the pandemic, and may focus on:

- the utilization of exception reports to identify concerning sales practices;
- the time that elapses between when an exception report is generated, reviewed, and closed;
- the form of investigation conducted by persons reviewing exceptions reports (*i.e.*, whether the customer is contacted or any independent verification occurs beyond questioning – and accepting the representations of – the potentially offending RR).

A similar review could be conducted on customer complaints.⁴⁰

E. Repealing COVID-Related Regulatory Accommodations

A number of States provided BDs with temporary regulatory relief from examination and fingerprinting requirements; mandatory, on-site branch office inspections; and flexibility in the timeline for compliance with, and/or outright relief from, RR registration requirements for RRs working remotely. The States have begun to repeal, allow to expire, or issue superseding versions of those prior orders. NASAA has endeavored to track the States COVID-related orders on its website at: <https://www.nasaa.org/industry-resources/covid-19-updates/>.

F. Miscellaneous Observations

- *A note about disclosure and an RRs’ regulatory obligations.* In addition to BDs, RRs also have direct, personal responsibility for complying with Reg BI, suitability and anti-fraud provisions. A good starting point (that the States seem to agree with as well) for what that means is:
 - 1) RRs must (a) have a general understanding of the full range of securities products that are available in the market, (b) a specific understanding of the mechanics and details of any product the RR is selling, (c) know the customer⁴¹ to whom the RR is selling, and (d) take reasonable steps to ensure the customer understands that the RR is trying to sell them something (and if they buy it, the RR will make money).

- There is no supervisory system or investment product review committee or conflict committee that can make up for incompetent or ill-informed RRs.

2) If the RR is concerned that if the client knows X, then the client will not buy the product, that probably means that X is material information that should be fully and conspicuously disclosed to the customer at point of sale.

- States have observed that some investors and RRs increasingly view the public securities markets as inflated, and (worse) unpredictable – no longer tethered to a reasonable multiplier of a company's intrinsic value. Fraudsters are leveraging this concern, as well as anxious memories of the market crash that followed the Roaring 1920s (which followed the 1919 pandemic), and historic levels of mistrust in government and institutions, to entice investors and RRs (who sometimes also drink the proverbial Kool-Aid) into phony FX, precious metals, crypto, and real estate private placement schemes. Practitioners may find helpful ideas for email search lexicons, designed to detect selling away and undisclosed OBAs, by reviewing advertising during late night television, hard line talk radio, and other media sources (internet forums, social media feeds, etc.) that couch financial advice inside an anti-establishment or a conspiratorial context.
- States with resource-intensive state-registered IA examination programs may be more likely to conduct Reg BI exams using the NEMO Complex Products modules, given the relative ease of that approach; whereas other States may come onsite to conduct a more fulsome, all-books-and-records examination. The Committee does not proscribe the type or scope of suggested examinations conducted by the States relative to the Reg BI initiative (or otherwise).
- The ongoing litigation between the Massachusetts Securities Division ("MSD") and Robinhood Financial LLC has seemingly highlighted a new challenge for regulators seeking to protect at least some segment of Main Street investors. In an April 15, 2021 blog post, Robinhood (a BD) called MSD an "elitist" regulator that had deemed Robinhood's clients "naïve" and sought to "reinstate the financial barriers" that historically (according to Robinhood) worked to exclude "younger, and more diverse investors" from the securities markets. The post's sentiment is presumably aimed at cultivating grass roots support for a return to something closer to a caveat emptor philosophy, entirely antithetical to the direction the States are working toward to enforce Reg BI.
- In his testimony before the House Financial Services Committee on May 6, 2021, Chairman Gensler explained that he has directed the SEC's staff to consider – among other things – how Reg BI should be applied to the use of trading apps, and the predictive analytics that underlie these apps. To that end, States and practitioners might consider what implications, if any, the push methods used to bring users onto trading sites and the manner in which securities are displayed on those sites impact current-understanding of terms like "self-directed brokerage" and "solicited" versus "unsolicited" orders. Other questions raised by the Reddit-Gamestop-Robinhood event in late January 2021 worth considering might also include:
 - whether web-based BDs owe a minimum level of customer service to clients, such as a phone number that customers can call when trading is frozen, or a stock price is plummeting, and if so, whether the persons answering those calls need to be licensed and registered in the states;⁴²
 - whether supervisory review expectations differ for approval of margin or options accounts when the trading will most likely be done using a smart phone as compared to a computer;
 - whether additional information or investor education resources should be provided to customers before permitting customers to engage in options or margin trading through a BD.

If you have any questions about States' examinations and enforcement priorities for BDs, or about the regulation of the investment management and broker-dealer industries generally, please feel free to contact us.

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Footnotes

¹ Retail investors, of course, are no longer limited to mom-and-pop Boomers. They also include members of Gens X, Y and Z.

² Unless there is an exemption, BDs and RRs are generally required to register and submit to the jurisdiction of the state's securities administrator in every state where the BD or RR is engaged in securities business. In practice, this usually means that BDs and RRs must register in each state where they are physically located and each state where their clients are located.

³ While the majority of jurisdictions' securities acts are based upon one of the two model securities acts, it is critical that practitioners review the laws and, sometimes more importantly, the rules and regulations promulgated in each jurisdiction in which the BD conducts securities business to identify requirements that are particular to a jurisdiction. For example: Under Indiana's administrative code, 710 IAC 4-7-6(d)(9), a BD must conduct an annual compliance examination of each of its branch offices located in Indiana. Under New Mexico's administrative code, N.M. Code R. 12.11.2.24, every BD must employ at its principal office and at each branch in New Mexico at least one person designated to act in a supervisory capacity who is registered as an RR in N.M. and has either the series 8, 9/10, or 24 supervisory/principal designation (i.e., New Mexico does not permit remote, out-of-state supervision of RRs).

⁴ For a list of NASAA's committees and project groups please see: <https://www.nasaa.org/about/committees-and-project-groups>.

⁵ See NASAA Comment Letter to SEC Regarding Proposed Regulation Best Interest and Related Rulemakings, File No. S7-07-18 (Feb. 19, 2019), available at <https://www.nasaa.org/wp-content/uploads/2019/12/NASAA-Reg-BI-Supplemental-Comment-Letter-021919.pdf>; NASAA Comment Letter to SEC Regarding Proposed Regulation Best Interest and Related Rulemakings, File No. S7-07-18 (Aug. 23, 2018), available at <https://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Reg-BI-Comment-Letter-8-23-2018.pdf>; NASAA Initial Comment Letter to SEC Regarding Proposed Regulation Best Interest and Related Rulemakings (Aug. 7, 2018), available at <https://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Initial-Comment-Letter-Reg-BI-8-7-18.pdf>.

⁶ See Prepared Statement of SEC Chairman Gary Gensler before the House Financial Services Committee (May 5, 2021), available at <https://www.sec.gov/news/testimony/gensler-testimony-20210505>.

⁷ See, e.g., SEC Final Rule, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Release No. 34-86031, at 38 (noting that the BI standard "does not necessarily require the 'lowest cost option'", available at <https://www.sec.gov/rules/final/2019/34-86031.pdf>; *Id.* at 284 (noting that an RR need only consider "reasonably available alternatives offered by the BD," rather than "all available alternatives," when determining whether the BD has a reasonable basis for believing that a product is in the customer's best interest) (emphasis added); SEC, *Frequently Asked Questions on Regulation Best Interest* (last modified Aug. 4, 2020), available at <https://www.sec.gov/tm/faq-regulation-best-interest>; SEC, *Examinations that Focus on Compliance with Regulation Best Interest*, at 2 (April 7, 2020), available at <https://www.sec.gov/files/Risk%20Alert-%20Regulation%20Best%20Interest%20Exams.pdf> (noting that initial examinations of BD compliance with Regulation BI will focus on assessing whether BDs "have made a good faith effort to implement policies and procedures reasonably designed to comply with Regulation BI") (emphasis added).

⁸ The Phase One survey was often provided to BDs in the form of a subpoena, primarily in an effort to ensure the maximum available protection from compulsory provision in response to a freedom of information request made under a state's public records laws. The investigatory privilege over information obtained by the States pursuant to a subpoena is considered the best protection available for shielding the BDs' responses to the survey.

⁹ The survey included the 50 largest BDs, by number of RRs. See *infra* note 11, NASAA Phase 1 Report, fn. 3.

¹⁰ The following states participated in Phase One: Alabama, Alaska, Arkansas, California, Colorado, Connecticut, District of Columbia, Delaware, Florida, Georgia, Illinois, Indiana, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Jersey, New Mexico, New York, Ohio, Oklahoma, Oregon, Rhode Island, Texas, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.

¹¹ NASAA Regulation Best Interest Implementation Committee, *Regulation Best Interest: National Initiative Phase One* (Sept. 2020), available at <https://www.nasaa.org/wp-content/uploads/2020/09/Reg-BI-Phase-1-Report.pdf> [hereinafter referred to as "NASAA Phase 1 Report"].

¹² About two-thirds of the BDs surveyed did not have these. See *supra* note 10, NASAA Phase 1 Report, at pages 7-8.

¹³ *Id.* at page 8.

¹⁴ *Id.*

¹⁵ *Id.* at pg. 9.



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