



Financial Services & Products ADVISORY ■

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FINRA Proposes Rule Updates to Conform with Reg BI—But State Suitability Standards Remain an Open Question

In response to the fast-approaching compliance date for the Securities and Exchange Commission's (SEC) Regulation Best Interest (Reg BI), the Financial Industry Regulatory Authority (FINRA) has [proposed changes to its own rules](#) to reflect the enhanced "best interest" standard of care for retail transactions and other restrictions imposed by Reg BI. While this resolves the outstanding question of what will become of FINRA's suitability-based rules, it still leaves open other lingering suitability-based questions, including the state-level suitability requirements that apply to transactions in publicly registered, non-listed REITs (PNLRs), publicly registered, non-listed business development companies (PNL BDCs), and direct participation programs (DPPs), and more aggressive fiduciary-standard rules imposed by states like Massachusetts.

Reg BI in Summary

As of June 30, 2020, [Reg BI](#) will require all broker-dealers that recommend a securities transaction to any "retail customer" (defined to include all natural persons or their legal representatives who receive a recommendation from a broker-dealer and use it primarily for personal, family, or household purposes) to, among other things, meet an enhanced "best interest" standard of care in making that recommendation. This new standard enhances and replaces, by and large, the application of the long-standing "suitability" requirement in FINRA's Rule 2111.

Under the [existing FINRA suitability rule](#), broker-dealers have been required, in making any recommendation to a customer, to "have a reasonable basis to believe" that the recommendation is "suitable" for the customer, "based on the information obtained through the reasonable diligence of the [broker-dealer] to ascertain the customer's investment profile." In comparison, Reg BI will now require, as its core obligation, that for any securities recommendation made to a retail customer, broker-dealers "exercise reasonable diligence, care, and skill to ... have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's 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] ahead of the interest of the retail customer." This standard-of-care obligation for individual recommendations is part of a four-prong standard that must be met under Reg BI, in addition to other more generalized care obligations (including that the recommendation could be in the best interest of at least some retail customers and that a string of transactions or recommendations, taken together, are in the best interest of the customer), as well as several disclosure, conflicts of interest, and compliance-related obligations.

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Among the four component obligations imposed by Reg BI, broker-dealers must have policies and procedures reasonably designed to address conflicts of interest associated with making recommendations to customers. These include identifying and, at a minimum, disclosing all conflicts of interest associated with such recommendations and identifying and mitigating any conflicts of interest that create an incentive for an associated person to place their interest ahead of the retail customer's interest. In addition, Reg BI requires broker-dealers to identify and eliminate "sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time."

Changes to FINRA Suitability and Non-Cash Compensation Rules

Beyond the multitude of questions about how exactly to parse the substantive requirements of Reg BI, one of the lingering questions it raised is how to address the clear conflict between Reg BI and FINRA's existing suitability provision, and other questions such as how Reg BI's restriction on sales contests, quotas, bonuses, and non-cash compensation should be folded into other relevant FINRA rules, including Rule 2310, which governs sales of shares of PNLRs, PNL BDCs, and DPPs and restricts the use of non-cash compensation. In order to clarify the inconsistencies between these rules, FINRA has proposed amendments to several of its rules. FINRA has proposed to amend its suitability rules by appending an additional note in its "Supplementary Material" that expressly acknowledges that they "shall not apply to recommendations subject to Reg BI" (in addition to Rule 2111, FINRA has a distinct suitability rule that applies to limited-purpose capital acquisition brokers). While some industry members had questioned whether, in light of Reg BI, there would be a continued need for FINRA Rule 2111, FINRA says in its rule proposal that because "Reg BI applies only to recommendations to 'retail customers' ... FINRA's suitability rule is still needed for entities and institutions (e.g., pension funds), and natural persons who will not use recommendations primarily for personal, family, or household purposes (e.g., small business owners and charitable trusts)."

FINRA has also proposed changes to the several rules that have restrictions or references involving non-cash compensation and sales contests (specifically, Rules 2310 (Direct Participation Programs); 2320 (Variable Contracts of an Insurance Company); 2341 (Investment Company Securities), which governs mutual funds and interval funds; and 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements), which governs tender offer closed-end funds), noting that any non-cash compensation arrangements to associated persons "must be consistent with the applicable requirements of" Reg BI. FINRA has further eliminated references in those rules to potentially permissible sales-target-based compensation in light of Reg BI's prohibitions related to sales contests.

Implications of NASAA Guidelines and State-Specific Restrictions

An additional, and as-of-yet unresolved, issue raised by Reg BI is state-level, product-specific regulations governing the sale of securities. In particular, issuers and sellers of PNLRs, PNL BDCs, and DPPs are forced to grapple with whether and how they should modify their procedures and the state-specific obligations imposed on the sale of the securities of PNLRs, PNL BDCs, and DPPs, primarily reflected in the guidelines created by the North American Securities Administrators Association (NASAA). The REIT Guidelines were adopted and amended in 2007 by the 53 individual state securities regulators that form the primary membership of NASAA and impose additional requirements on the sale of PNLRs at the state level, including a general requirement that PNLR sponsors, and persons selling on their behalf (most often broker-dealers) (the selling agent), "shall make every reasonable effort to determine that the purchase of [PNLR shares] is a suitable and appropriate investment for each shareholder." The Omnibus Guidelines, which were also adopted and amended in 2007 and impose requirements on PNL BDCs, contain a similar requirement regarding determination of suitability. Tender offer closed-end funds and interval funds are registered investment companies and "covered securities" and are therefore exempt from specific NASAA registration requirements.

The REIT Guidelines and Omnibus Guidelines additionally require that PNLB and PNL BDC sponsors require minimum income and net-worth standards for purchase of the PNLB or PNL BDC shares, taking into account a variety of factors, and that the sponsor or selling agent confirms that the subscriber meets the minimum income and net-worth standards for the PNLB and PNL BDC, can “reasonably benefit” from the purchase of the PNLB or PNL BDC shares based on the person’s “overall investment objectives and portfolio structure,” and has an “apparent understanding” of several specific factors, including liquidity and transferability of the investment. The REIT Guidelines and Omnibus Guidelines require that the sponsor or selling agent must base its suitability determination on relevant information obtained from the subscriber, including at least their age, investment objectives, investment experience, income, net worth, financial situation, and other investments held.

NASAA and its individual state members have yet to take any specific action to square away the REIT Guidelines and Omnibus Guidelines and related state-specific restrictions on PNLB and PNL BDC sales with the new requirements of Reg BI. This inaction is likely at least partially explained by broader recent actions taken by state regulators, most notably Massachusetts, to adopt a further enhanced fiduciary standard of care for broker-dealers operating within their state, which have arisen out of dissatisfaction with the SEC’s “best interest” standard. However, in the meantime, broker-dealers are left with little more than three months to finalize their Reg BI compliance procedures, which it appears may not have the benefit of any updated guidance from NASAA before the Reg BI compliance date. NASAA has stated that it has formed a subcommittee to examine its model suitability standards and is surveying individual state regulators for feedback on a new model, but the status of those efforts is currently unclear.

Moving Forward with Reg BI and the Applicable NASAA Guidelines

Broker-dealers subject to Reg BI should already have their Reg BI compliance planning well underway and should of course remain mindful of the results of FINRA’s proposed rule changes in implementing their Reg BI policies and procedures. Given the uncertainty around NASAA and state-level action on the REIT Guidelines and Omnibus Guidelines, PNLB and PNL BDC sponsors and selling agents should be reviewing their prospectuses, subscription and selling agreements, and relevant policies and procedures to ensure that current procedures are enhanced as needed per Reg BI but that the technical specifications required by the REIT Guidelines and Omnibus Guidelines are not displaced by those efforts. For example, while the enhanced nature of the “best interest” standard under Reg BI would generally appear to meet or exceed the general “suitability” assessment required under the REIT Guidelines and Omnibus Guidelines, and thus arguably preempt the REIT Guidelines and Omnibus Guidelines in that regard, the generally enhanced nature of the best interest standard would not appear to satisfy or negate the technical requirements of the REIT Guidelines and Omnibus Guidelines for minimum income and net-worth standards and required understandings of the product type.

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