



In the blitz of regulatory and financial developments that have made headlines throughout the first quarter of 2023, a recent [FINRA enforcement action](#) serves as a reminder to both broker-dealers and their representatives that Regulation Best Interest (Reg BI) remains an area of focus for FINRA. This action underscores how important it is for broker-dealers to ensure that their representatives fully understand the risks and other features of complex financial products, make only suitable recommendations, and otherwise comply with Reg BI.

The Relevant Regulatory Standards

Reg BI (Customer Best Interests)

[Reg BI](#) requires broker-dealers and their representatives to act in the best interest of retail customers when making a recommendation regarding any securities transaction or investment strategy. The care obligation, set forth at Section (a)(2)(ii) of the rule, requires broker-dealers and their representatives to exercise reasonable diligence, care, and skill to, among other things, 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. As noted in the Letter of Acceptance, Waiver, and Consent (AWC), the SEC's [adopting release for Reg BI](#) states that whether reasonable diligence, care and skill exist

[depends] on, among other things, the complexity of, and risks associated with the recommended security . . . and the broker-dealer's familiarity with the recommended security"

FINRA Rule 2111 (Suitability)

[FINRA Rule 2111](#) requires broker-dealers and their representatives to have a reasonable basis for believing that a recommended transaction or investment strategy is suitable for the customer based on the customer's investment profile.

FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade)

[FINRA Rule 2010](#) requires broker-dealers to observe high standards of commercial honor and just and equitable principles of trade.

Recommendations without a Reasonable Basis

In the recent action, the representative settled the AWC with FINRA and was fined for recommending unsuitable leveraged and inverse ETFs to retail customers without having a sufficient understanding of the product risks and features. As stated in the AWC, the representative should have been particularly mindful in light of FINRA's previous [Regulatory Notice 09-31](#), which notified and alerted members that complex ETFs, such as those that offer leverage or are designed to perform inversely to an index, "typically are not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets."

Considering the facts at issue in the AWC, FINRA determined that the representative did not have a reasonable basis for making the recommendations because, among other things, he

did not understand that losses in leveraged and inverse exchange-traded funds can be compounded because of the daily reset function."

FINRA cited the representative for violating Reg BI's care obligation and FINRA Rules 2111 and 2010. The representative was fined \$2,500, required to make restitution to the customers that lost money based on his recommendations, and suspended for three-months.

Key Takeaways

- Reg BI continues to be a regulatory priority for FINRA.
- Broker-dealers must train, test and monitor their representatives to ensure they understand complex financial products and are capable of assessing for whom such products are appropriate.

- Broker-dealers should also ensure that along with the customer's age, income, investment objectives, investment horizon, and other information, that data regarding the customer's indebtedness is also collected and factored into the analysis.

Explore more in

[Investment Management](#)

Blog series

Asset Management ADVocate

The Asset Management ADVocate provides unique analysis and insight into legal developments affecting asset managers in the United States. [Subscribe ?](#)

[View the blog](#)