Corporate Finance
Registration Update

The Division's Corporate Finance/ Registration Section registers securities offered for sale to Ohioans.

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Reg BI Now In Effect

The landscape of securities regulation continued to shift this quarter when Regulation Best Interest ("Reg BI") became effective. Reg BI enhances the standard of care imposed on broker-dealers in relation to their retail customers and will require them to:

(1) act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer; and

(2) address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest, and in instances where we have determined disclosure is insufficient to reasonably address the conflict, to mitigate or, in certain instances, eliminate the conflict. [1]

In addition to Reg BI, several jurisdictions have proposed conduct standards for broker-dealers. For example, New Jersey,[2] Massachusetts,[3] and Nevada[4] have proposed rules that would impose fiduciary standards on broker-dealers. Other conduct standards for broker-dealers are possible from state securities agencies or the U.S. Department of Labor.

While Reg BI and the other standards impose compliance obligations directly on broker-dealers and their firms, issuers of securities should also be mindful of how these standards should be disclosed in their offering materials. This is especially true for issuers of high-cost, high-risk, and complex products that have retained (or reserved the right to retain) broker-dealers.[5] As a result, the Division is asking such issuers to incorporate at least the following changes:

1. **Cover Page/Legend Disclosure**. We are concerned issuers or broker-dealers may believe the mere fact an offering is registered in a particular jurisdiction means it can be sold in compliance with Reg BI or other conduct standards. As a result, we are asking issuers to include a legend on the cover page stating:

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[1] SEC releases, i.e. *Final Rule; Regulation Best Interest: The Broker-Dealer Standard of Conduct*, 84 Fed Reg. 33,381 (July 12, 2019) (the "Regulation BI Adopting Release") (codified at 17 C.F.R. 240.15l–1).
[2] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisors and Investment Adviser Representatives, 51 N.J.R. 493(a) (proposed April 15, 2019) (to be codified at N.J.A.C. 13:46A-6.4).
[3] *Adoption of Amendments to Fiduciary Conduct Standard Regulations*, William Francis Galvin, Secretary of the Commonwealth of Massachusetts (Feb. 21, 2020), http://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryrule-adoption.htm.
[4] Fiduciary Duty Regulations, NRS 90.575 (2017).
[5] Item 508 of Regulation S-K requires issuers to disclose arrangements with underwriters and broker-dealers.

Securities regulators have not passed upon whether this offering can be sold in compliance with existing or future suitability or conduct standards including the 'Regulation Best Interest' standard to any or all purchasers.

2. **Suitability Section Updates**. Both the SEC and FINRA have referred to Reg BI as an enhancement of existing suitability standards.[6] Issuers should disclose appropriate Reg BI and other conduct standard disclosures into suitability sections or in close proximity to the suitability section as a stand-alone section. This disclosure should include at least the following:
   i. Regulation Best Interest adoption date;
   ii. Regulation Best Interest may be interpreted as a higher standard than suitability;
   iii. Regulation Best Interest may be more restrictive than the quantitative standards currently described in the suitability section;
   iv. The basic requirements of Regulation Best Interest include the general obligation and four component parts (the disclosure obligation, the care obligation, the conflict of interest obligation and the compliance obligation); and
   v. No administrative or case law exists under Regulation Best Interest and the full scope of its applicability is uncertain.

3. **Subscription Agreement Changes**. Similarly, if an issuer addresses suitability in its subscription agreement, it should now make corresponding adjustments to the subscription agreement where suitability is referenced.

4. **Additional Risk Factors**. Many offering circulars disclose the risk of not reaching the minimum offering amount or raising substantial funds. For example, one real estate issuer disclosed if it were to "raise substantially less than the maximum offering, [it] may not be able to invest in a diverse portfolio of income-producing commercial properties and other real estate-related assets."

The Division asserts the interpretation and/or application of conduct standards by broker-dealers may affect whether some broker-dealers decide to recommend these offerings to customers. High-cost, high-risk, and complex products should disclose the risks of being subject to greater scrutiny by broker-dealers, that broker-dealers are under a duty of care to evaluate other alternatives in the purchaser's best interest and other alternatives are likely to exist.

Brokers should note this is not purely a matter of federal law; Ohio Revised Code section 1707.44(L) prohibits dealers from engaging in any conduct "that violates the provisions of section 15(c) or 15(g) of the 'Securities Exchange Act of 1934,' 48 Stat. 881, 15 U.S.C.A. 78o(c) or (g), or any rule or regulation promulgated by the securities and exchange commission

[6] *See* Regulation BI Adopting Release *at 33318-33319 (stating* that Reg BI will improve investor protection by "[e]nhancing the obligations that apply when a broker-dealer makes a recommendation to a retail customer… and reducing the potential harm to retail customers from conflicts of interest that may affect the recommendation."); Notice of Filing of a Proposed Rule Change to FINRA's Suitability, Non-Cash Compensation and Capital Acquisition Broker (CAB) Rules in Response to Regulation Best Interest, 85 Fed. Reg. 16,974 (Mar. 25, 2020) (stating that "[t]wo key enhancements are that Reg BI explicitly imposes a best interest standard and explicitly requires a consideration of costs.")

thereunder."[7] The Division requires issuers to provide the names and CRD numbers of broker-dealers that have agreed to offer the securities of the issuers and may also evaluate the compliance of broker-dealers selling high risk and complex products.

[7] Ohio Rev. Code. Ann. §1707.44(L).