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# 5. CUSTOMER ACCOUNTS

## **5.7 Regulation Best Interest – Reg BI**

The SEC adopted Regulation Best Interest (with a compliance effective date of **June 30, 2020**), which establishes a new standard of conduct under the Securities Exchange Act of 1934 (“Exchange Act”) for broker-dealers and natural persons who are associated persons of a broker-dealer (“associated persons”) when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer.

When making such a recommendation to a retail customer, Company must act in the best interest of the retail customer at the time the recommendation is made, without placing Company’s financial or other interest ahead of the retail customer’s interests.

This ***general obligation*** is satisfied only if you comply with four specified ***component obligations*:**

1. ***Disclosure Obligation*:** provide certain required disclosure before or at the time of the recommendation, about the recommendation and the relationship between the Company and its retail customer. This would include both a Form CRS that explains the capacity in which the Company and Associated Person will be acting for the account when it is opened and further, any specific product disclosure forms that explain applicable fees and other pertinent information;
2. ***Care Obligation*:** exercise reasonable diligence, care, and skill in making the recommendation;
3. ***Conflict of Interest Obligation***: establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest; and
4. ***Compliance Obligation*:** establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

### **5.7.1 Definitions**

**Accounts**: Recommendations include account types generally (e.g., to open an IRA or other brokerage account), as well as recommendations to roll over or transfer assets from one type of account to another (e.g., a workplace retirement plan account to an IRA).

**Affiliate**: Any persons directly or indirectly controlling or controlled by Company or under common control with Company.

**Best Interest**: The term "best interest" is explained through SEC guidance and interpretations and is not expressly defined. Whether a broker-dealer has acted in the retail customer's best interest in compliance with Regulation BI will turn on an objective assessment of the facts and circumstances of how the specific components of Regulation BI - including its Disclosure, Care, Conflict of Interest, and Compliance Obligations - are satisfied at the time that the recommendation is made (and not in hindsight).

**Conflict of Interest**: A conflict of interest is an interest that might incline a broker-dealer or RR, consciously or unconsciously, to make a recommendation that is not disinterested.

**Customer Relationship Summary**: A written disclosure statement (Form CRS) that must be provided to retail investors when a recommendation is made (as defined in Reg BI).

**Dual Registrant**: A firm that is dually registered as a broker-dealer under section 15 of the Exchange Act and an investment adviser under section 203 of the Advisers Act and offers services to retail investors as both a broker-dealer and an investment adviser. There are exceptions; for example, if a BD dually registered offers investment advisory services to retail investors, but offers brokerage services only to institutional investors, the BD is not a dual registrant for purposes of Form CRS. In the case of Company, it has an affiliated investment advisor company and therefore chooses to publish one Form CRS.

**Full and Fair**: Sufficient information to enable a retail customer to make an informed decision with regard to a recommendation.

**Legal Representative**: “Legal representative” includes the non-professional legal representatives of such a natural person, e.g., a non-professional trustee that represents the assets of a natural person. Reg BI would not apply when the legal representative is acting in a professional capacity as a regulated financial services industry professional retained to exercise independent professional judgment. Therefore, recommendations to registered IAs and BDs or corporate fiduciaries would not trigger Reg BI. On the other hand, recommendations to non-professional trustees, executors, conservators and persons holding power of attorney that represent natural persons are covered.

**Personal, Family, or Household Purposes**: The phrase “primarily for personal, family, or household purposes” covers any recommendation to a natural person for his or her account, other than recommendations to a natural person seeking these services for commercial or business purposes. Reg BI would not cover, for example, an employee seeking services for an employer or an individual seeking services for a small business or on behalf of another non-natural person entity, such as a charitable trust.

**Receives and Uses**: The term “use” means when, as a result of the recommendation:

* The retail customer opens a brokerage account with the Company, regardless of whether the Company receives compensation;
* The retail customer has an existing account with the Company and receives a recommendation from the Company, regardless of whether they receive or will receive compensation, directly or indirectly, as a result of the recommendation; or
* The Company 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.

**Recommendation**: whether a recommendation has been made is not susceptible to a bright line definition. Factors considered in determining whether a recommendation has taken place include whether the communication “reasonably could be viewed as a ‘call to action’” and “reasonably would influence an investor to trade a particular security or group of securities.” The more individually tailored the communication to a specific customer or targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a “recommendation.”

However, Regulation Best Interest does not apply to investment advice provided to a retail customer by a dual-registrant when acting in the capacity of an investment adviser, even if the retail customer has a brokerage relationship with the dual-registrant or the dual-registrant executes the transaction in a brokerage capacity.

**Retail Customer**: A “retail customer” as a natural person, or the legal representative of such person, who: (a) receives a recommendation for any securities transaction or investment strategy from a BD or AP; and (b) uses the recommendation primarily for personal, family or household purposes.

### **5.7.2 Disclosure Obligation**

The obligation to provide full and fair disclosure should give sufficient information to enable a retail investor to make an informed decision with regard to a recommendation.

The disclosure obligation requires a BD or RR, prior to or at the time of the recommendation, to provide the retail customer, in writing, full and fair disclosure of:

* All material facts relating to the scope and terms of the relationship with the retail customer, including:
  + That the BD or associated person is acting as a BD or an associated person with respect to the recommendation;
  + The material fees and costs that apply to the retail customer's transactions, holdings, and accounts;
  + The type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer; and
  + Material facts relating to conflicts of interest that are associated with the recommendation. "Material facts" are facts a retail customer would consider important in making an investment decision. For example, material facts relating to conflicts of interest including, but not limited to, how RRs are compensated and the benefits to a BD from recommending a proprietary product.
* Other material facts relating to the scope and terms of the relationship with the retail customer which include:
  + The general basis for a recommendation (*i.e.,* what might commonly be described as investment approach, philosophy, or strategy); and
  + Risks associated with recommendations in standardized terms.
* If necessary, other material facts relating to the scope and terms of the relationship.

Disclosures are provided in a variety of ways, including (but not necessarily limited to) the following:

* Electronic mailings to those who have consented to receive electronic delivery
* Form CRS Relationship Summary
* Account opening documents and account agreements
* Company's website

While disclosures must be in writing, in certain circumstances oral disclosures (no later than the time of the transaction) to supplement facts not reasonably known at the time written disclosure is made.

### **5.7.3 Care Obligation**

The care obligation is broader than the existing suitability standard because it: (1) explicitly requires that the recommendation be in the customer's best interest and that the Company and RRs do not place their interests ahead of the customer; (2) explicitly requires that cost be a consideration; (3) applies the quantitative suitability requirement (recommending a series of transactions, avoiding excessive activity); and (4) requires the Company and RRs to consider "reasonably available alternatives" as part of having a "reasonable basis to believe" that the recommendation is in the best interests of the customer.

The RR must exercise reasonable diligence, care, and skill to:

* understand the risks, rewards, and costs associated with the recommendation;
* have a reasonable basis to believe the recommendation is in the customer's best interest; and
* have a reasonable basis to believe that recommended transactions are in the customer's best interest based on the customer's investment profile and doesn't place the interests of the Company ahead of the customer. This includes avoiding transactions that are excessive.

In particular, Company and RRs must understand complex products, and recommendations of complex investments should be documented, particularly where a recommendation may seem inconsistent with a retail customer's objectives on its face. The care obligation applies to a series of recommended transactions (quantitative suitability).

#### 5.7.3.1 Factors to Consider

When making recommendations, the following non-exclusive list of factors (depending on the particular product or strategy recommended) may be considered:

* What are the characteristics (including any special or unusual features) of the security or strategy?
* What are the initial and subsequent costs (if any, *e.g.,* surrender or redemption costs) of the security or strategy?
* How liquid is the security?
* What are the risks, volatility, and likely performance in a variety of market conditions (normal or stressed)?
* What is the expected return of the security?
* What are the financial incentives to recommend the security or investment strategy?
* Are there alternative investments or strategies, at lower cost, that may meet the customer's needs? More costly products may be recommended provided there is a reasonable basis to believe they are in the best interest of the customer. There is no obligation to recommend the "best" of all possible alternatives.

#### 5.7.3.2 Recommending Types of Accounts

RRs must have a reasonable basis for recommending accounts (margin, brokerage or advisory, IRAs, *etc.*). This includes the following considerations:

* services and products provided in the account;
* projected cost of the account;
* alternative account types available;
* services the retail customer requests; and
* the retail customer's investment profile. Profile elements include age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information disclosed by the customer.

Additional considerations when recommending IRAs (including rollovers or transfers of assets in a workplace retirement plan account to an IRA) include:

* customer's current financial situation and liquidity needs;
* fees and expenses;
* level of services available;
* ability to take penalty-free withdrawals;
* application of required minimum distributions;
* protections from creditors and legal judgments;
* holdings of employer stock; and
* any special features of the existing account.

#### 5.7.3.3 Costs

The RR should understand and consider the potential costs associated with the recommendation and have a reasonable basis to believe that the recommendation does not place the financial or other interest of Company or RR ahead of the interest of the retail customer. While cost must be considered, it should never be the only consideration. Cost is only one of many important factors to be considered regarding the recommendation and that the standard does not necessarily require the "lowest cost option." RRs need to consider costs in light of other factors and the retail customer's investment profile.

#### 5.7.3.4 Alternatives

Alternatives should be considered before making recommendations to a particular retail customer. This does not mean customers must be offered all alternatives or necessarily the lowest-cost alternative or the "single best" alternative. Reasonably available alternatives include considerations of, for example:

* An RR's customer base (including the general investment objectives and needs of the customer base)
* Investments and services available to the RR to recommend (including limitations due to the RR's licensing)
* Specific limitations on the available investments and services with respect to certain retail investors (*e.g.,* product or service income thresholds; product geographic limitations; or product limitations based on account type, such as those only eligible for IRA accounts)

#### 5.7.3.5 Quantitative Suitability

RRs may not make recommendations that result in transactions excessive for the customer considering the customer's investment objectives (also known as "churning"). A series of recommended transactions must be in the customer's best interest. The customer may be contacted by Company to confirm that active trading is appropriate.

#### 5.7.3.6 Material Limitations

If Company materially limits its product offerings to certain proprietary or other limited menus of products or third-party arrangements, its limited menu does not justify a product recommendation that is not in the customer's best interest.

### **5.7.4 Conflict of Interest Obligation**

A conflict of interest is an interest that might incline a BD or an RR - consciously or subconsciously - to make a recommendation that is not disinterested. Conflicts may exist between the BD and the retail customer; between the RR and the retail customer; and between the BD and the RR. Additional conflicts may exist between customers (*e.g.,* IPO allocations or proprietary research or advice among different types of customers).

Company has an obligation to avoid or mitigate conflicts of interest where possible and provide disclosure where conflicts may exist.

Company will identify conflicts and, where appropriate, identify material limitations placed on the investment product or strategy and any conflicts associated with such limitations (*e.g.,* limited product menu, proprietary products only, *etc.*) and make necessary disclosures. In addition, the Annual Regulatory Checklist will also help to detect any unreported conflicts.

Depending on a product’s complexity, an enhanced product review process may serve in identifying material limitations or conflicts of interest. Company could either decline to recommend the product or offer further disclosures when a conflict cannot be mitigated.

Incentive programs (whether provided by Company or a third party) such as sales contests, sales quotas, bonuses, non-cash compensation, *etc.,* within a limited period of time are prohibited if they are based on:

* a specific product; or
* types of securities.

This requirement is not intended to prohibit training or education meetings, provided they are not based on the sale of specific securities within a limited period of time.

RRs have an obligation to avoid conflicts of interest when dealing with retail customers; some examples are listed below.

1. Recommending proprietary products because they result in higher compensation without considering the customer's needs and alternative investments.
2. Recommending other products or services based on compensation/incentives from Company or third parties.

### **5.7.5 Compliance Obligation**

Company has adopted policies and procedures reasonably designed to achieve compliance with Reg BI It is the responsibility of RRs to be familiar with these requirements and act in the customer's best interest at all times. In addition, the remaining sections of 5.7 address further Compliance Obligations of the regulation. Questions should be referred to Compliance.

5.7.5.1 Controls

Company conducts reviews of the following:

* **New Accounts** – each account is reviewed and approved by a principal and Compliance which includes product selection verses the investment profile. and conducts an annual testing and internal review for policies and procedures.
* **Trades** – a Principal and Compliance review trades on a regular basis as well as Compliance reviews monitoring reports from the clearing firm that include excessive trading.
* **Policies and Procedures** – Company reviews and updates its policies and procedures on an ongoing basis to help ensure compliance with regulations. Form CRS will a
* **Annual Regulatory Checklist** – Company requires an annual regulatory checklist to ascertain any conflicts of interest that have not been reported to Company or that are forthcoming.
* **Internal Review** – Compliance conducts an annual review and testing of policies and procedures which will include compliance with Reg BI.
* **Form CRS** - Form CRS will also be reviewed at least on an annual basis to ensure information is current or if any material amendments may be required.

5.7.5.2 Non-Compliance

If Company becomes aware of non-compliance with a part of the regulation, Compliance and/or a principal will review and asses what action(s) may need to be taken to address the non-compliance or for remediation. This may include some of the following:

* A review of any discovered account and related transactions and take any necessary actions with a registered representative or customer to help remediate the issue.
* Review and update any gap in policies and procedures and add it to the annual review to ensure future compliance.
* Review and update the Form CRS if any material changes.
* Review and update any items that may need to be added to the annual regulatory checklist to capture that information.

#### 5.7.5.3 Training

Company conducts at least annual training for its Associated Persons. This includes the annual compliance meeting, continuing education, and intermittent training on compliance issues. Training may be conducted in person, online, telephonically, emailed notices, etc.; all in effort to ensure compliance with Reg BI and other regulations and Company procedures *(further information in Section 5.7.8).*

### **5.7.6 Form CRS (Customer Relationship Summary)**

Company’s Customer Relationship Summary (Form CRS), provides clients with succinct information about the relationships and services Company offers, fees and costs that clients will pay, specified conflicts of interest and standards of conduct, and disciplinary history, among other things. Since Company is a Broker/Dealer and has an affiliated RIA, one combined form will be used for both entities.

#### 5.7.6.1 Content

Morris Monroe (CCO) will ensure the Form CRS includes the following content:

* **Item 1 – Introduction**: The date appears prominently at the beginning of the Relationship Summary (*e.g.,* in the header or footer of the first page or in a similar location for a Relationship Summary provided electronically) and make the other requirements of Item 1 of Form CRS.
* **Item 2 - Relationships and Services**: Company's investment services offered to retail clients to be disclosed including summaries of the principal services, accounts, or investments it makes available to retail clients, and any material limitations on such services. Additionally, this section must include the five "conversational services" listed in Item 2.
* **Item 3 - Fees, Costs, Conflicts, and Standards of Conduct**: Describes Company’s fees, fixed fees, product level fees as well as other fees and costs related to its services.
* **Item 4 - Disciplinary History**: Disclose Company's disciplinary history in the Relationship Summary as well as the required "conversational starter."
* **Item 5 - Additional Information**: Sets forth where the retail client can find additional information about Company’s investment advisory services and request a copy of the relationship summary as well as a telephone number where retail investors can request up-to-date information and request a copy of the relationship summary. The required "conversational starter" must be included.

#### 5.7.6.2 Filings

Company and its affiliated RIA will have a period of time beginning on **May 1, 2020** until **June 30, 2020** to file its initial Relationship Summary. Both companies must file its Form CRS electronically with the SEC through the Central Registration Depository (Web CRD) operated by the Financial Industry Regulatory Authority, Inc. (FINRA), and thereafter, file an annual amended Form CRS in accordance with the instructions in Form CRS. Company will make such filing in a text-searchable format and the filing will be structured with machine-readable headings.

#### 5.7.6.3 Amendments

Company will file an amended Relationship Summary as another-than-annual amendment or by including the Relationship Summary as part of an annual updating amendment, within the 30 days in which they are required to file the amendment. Subsequently, Company will deliver to existing clients within 60 days the most recent changes including an exhibit highlighting or summarizing material changes filed. Company will submit amended versions of its Relationship Summary as part of its annual updating amendment.

#### 5.7.6.4 Initial Delivery to Clients

Company will be required to deliver its relationship summary (Form CRS) as follows:

* To all existing clients who are retail investors on an initial one-time basis within 30 days after the date Company is first required to file its Relationship Summary with FINRA; and
* To each new retail client after June 30, 2020, its current Relationship Summary (Form CRS) before or at the time a person or entity becomes a retail client. The copy date of any Form CRS provided will be recorded in WinOps in the customer record; and

#### 5.7.6.5 Other Delivery Requirements

Company will deliver to each retail client who is an existing customer its current Form CRS before or at the time Company:

* A new account is opened, or an existing client opens a new account that is different from the retail client's existing account(s);
* Recommends that the retail client roll over assets from a retirement account into a new or existing account or investment; or
* Recommends or provides a new investment advisory service or investment that does not necessarily involve the opening of a new account and would not be held in an existing account.
* Recommends a new investment strategy.
* Recommends or provides a new service or product that does not necessarily involve opening a new account or would not be held in an existing account (for example – the first-time purchase of a direct mutual fund or insurance product that is a security through a “check and application” process.
* Company will communicate any changes made to Form CRS to each retail investor who is an existing client within 60 days after the amendments are required to be made and without charge. The communication may be made by delivering the amended Form CRS or by communicating the information through another disclosure that is delivered to the retail investor (or a summary or highlighted information of the changes).
* Company will deliver a current Form CRS to each retail investor within 30 days upon request.

#### 5.7.6.6 Updates

Company must amend its Form CRS within 30 days whenever any information becomes materially inaccurate by filing with the SEC/FINRA an additional other-than-annual amendment or by including the Relationship Summary as part of an annual updating amendment. Updated summaries will be provided to customers within 60 days after material updates with changes highlighted. Updates may be provided electronically to customers who have consented to electronic delivery.

#### 5.7.6.7 Website

Company will post the current Form CRS prominently on its website, in a location and format that is easily accessible for retail clients.

#### 5.7.6.8 Dual Registrants

Dual registrants and affiliates (as defined in this chapter) are required to provide a Form CRS for both the broker-dealer and advisory relationships; the form may be combined. Broker-dealers have an obligation to file Form CRS with FINRA's CRD and advisers are required to file with IARD. Company and its affiliated RIA, Woodlands Asset Management, Inc., provide a combined form.

[SEC Form CRS instructions: <https://www.sec.gov/rules/final/2019/34-86032-appendix-b.pdf>; SEC FAQs on Form CRS: <https://www.sec.gov/info/smallbus/secg/form-crs-relationship-summary>; SEC Form CRS Relationship Summary Small Entity Compliance Guide: <https://www.sec.gov/info/smallbus/secg/form-crs-relationship-summary>].

### **5.7.7 Recordkeeping**

Records of all information collected from and provided to the retail customer shall be maintained in accordance with recordkeeping rules. Records are not required to evidence best interest determinations on a recommendation-by-recommendation basis. Company also is not required to provide information regarding the basis for each particular recommendation. Records of Form CRS delivery will be retained for six years after the earlier of the date that the account was closed or the date on which the information was collected, provided, replaced or updated. A record of any notice to a client or potential client will be maintained in WinOps (group notices may be kept in excel).

### **5.7.8 Training**

Company will ensure all Associated Persons are properly trained on Regulation BI and the corresponding Form CRS and Company’s policies and procedures related thereto. A record of any training and the content will be maintained by Company as part of its records for a period of three years.