

## 2020-13

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**Stakeholders**

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General Public

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June 30, 2020

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Fair Practice,  
Uniform Practice

**Affected Rules**

[Rule G-8](#), [Rule G-9](#), [Rule G-19](#), [Rule G-20](#), [Rule G-48](#)

## MSRB Harmonizes Rules with Requirements of Regulation Best Interest

### Overview

The Municipal Securities Rulemaking Board (MSRB) received approval<sup>1</sup> from the U.S. Securities and Exchange Commission (SEC or “Commission”) on June 25, 2020 of amendments to MSRB rules that align MSRB rules to the Commission’s recently adopted Rule 15I-1 under the Exchange Act<sup>2</sup> (“Regulation Best Interest”).

Pursuant to the amendments:

- Rule G-19 will apply only in circumstances in which Regulation Best Interest does not apply;
- Rule G-48 will make clear that the exception from the requirement to perform a customer-specific suitability analysis when making a recommendation to a Sophisticated Municipal Market Professional (“SMMP”), as defined in Rule D-15, is available only for recommendations that are subject to Rule G-19;
- Rule G-20 will require any permissible non-cash compensation to align with the requirements of Regulation Best Interest; and
- Dealers will be required to maintain books and records required by Regulation Best Interest and the related SEC Form CRS requirement.

### Effective Date

The effective date of the amendments to MSRB rules is June 30, 2020, which is the compliance date for Regulation Best Interest.



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<sup>1</sup> Exchange Act Release No. 89154 (June 25, 2020) (File No. SR-MSRB-2020-02).

<sup>2</sup> 17 CFR 240.15I-1.

## Brief Summary of the Amendments

### A. Background

Regulation Best Interest establishes a new standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer<sup>3</sup> (collectively, “broker-dealers”) when they make a recommendation to a retail customer, defined generally as a natural person or the legal representative of such person, who receives and uses a recommendation from a broker-dealer primarily for personal, family, or household purposes, of any securities transaction or investment strategy involving securities. The Commission stated that Regulation Best Interest enhances the broker-dealer standard of conduct beyond existing suitability obligations, and aligns the standard of conduct with retail customers’ reasonable expectations by imposing certain new requirements on broker-dealers.<sup>4</sup> Specifically, Regulation Best Interest imposes the following “general obligation”:

A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, shall 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, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.<sup>5</sup>

Regulation Best Interest provides that this general obligation is satisfied only if a broker-dealer complies with four component obligations: (i) an obligation to make certain prescribed disclosures, before or at the time of the

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<sup>3</sup> To effect transactions in municipal securities, a dealer must be registered with the Commission as either a broker-dealer under Section 15(b)(1) or a municipal securities dealer under Section 15B(a)(2) of the Exchange Act. All dealers, other than bank dealers, are broker-dealers and therefore are subject to Regulation Best Interest. Rule D-8 defines a bank dealer as “a municipal securities dealer which is a bank or a separately identifiable department or division of a bank.” These dealers are registered with the Commission under Exchange Section 15B(a)(2) and thus are not subject to Regulation Best Interest. The MSRB plans to issue a Request for Comment on whether the MSRB will apply the requirements of Regulation Best Interest to bank dealers through further amendments to MSRB rules.

<sup>4</sup> Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318 (July 12, 2019) (File No. S7-07-18) (“Regulation Best Interest Adopting Release”).

<sup>5</sup> 17 CFR 240.15I-1(a)(1).

recommendation, about the recommendation and the relationship between the retail customer and the broker-dealer (the “Disclosure Obligation”); (ii) an obligation to exercise reasonable diligence, care, and skill in making a recommendation (the “Care Obligation”); (iii) an obligation to establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest (the “Conflict of Interest Obligation”); and (iv) an obligation to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest (the “Compliance Obligation”).

The amendments harmonize the MSRB’s rules with Regulation Best Interest and the related Form CRS requirement<sup>6</sup> and reduce the potential for conflicting or duplicative regulation in the municipal securities market. The MSRB coordinated the amendments with FINRA in order to harmonize requirements, to the extent possible, for dealers that are subject to the rules of both the MSRB and FINRA.

## **B. Suitability**

### **1. Rule G-19**

Rule G-19 provides that a dealer must have a reasonable basis to believe that a recommended transaction or investment strategy involving municipal securities is suitable for the customer, based on the information obtained through the reasonable diligence of the dealer to ascertain the customer’s investment profile.<sup>7</sup> Rule G-19 is composed of three component obligations:

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<sup>6</sup> When it adopted Regulation Best Interest, the Commission also adopted a requirement for registered investment advisers and registered broker-dealers to provide retail investors with a relationship summary on new Form CRS, including information about the “types of client and customer relationships and services the firm offers; the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; whether the firm and its financial professionals currently have reportable legal or disciplinary history; and how to obtain additional information about the firm.” Exchange Act Release No. 86032 (June 5, 2019), 84 FR 33492 (July 12, 2019).

<sup>7</sup> Rule G-19 defines a customer’s investment profile to include the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the dealer in connection with such recommendation.

- *Reasonable-basis suitability*, which requires a dealer to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors;
- *Customer-specific suitability*, which requires a dealer to have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile; and
- *Quantitative suitability*, which requires a dealer who has actual or *de facto* control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile.

Rule G-19 applies to all dealers when making a recommendation to a “customer,” which is defined in Rule D-9 as any person other than a dealer acting in its capacity as a dealer or an issuer in transactions involving the sale of a new issue of its securities. When a dealer reasonably concludes that a customer is an SMMP, however, the dealer is not obligated to perform a customer-specific suitability analysis under Rule G-19.<sup>8</sup>

Conceptually similar to Rule G-19, the Care Obligation of Regulation Best Interest also requires a three-part analysis to evaluate recommendations to retail customers but employs the higher best interest standard instead of Rule G-19’s suitability standard. In addition, while Regulation Best Interest applies only to recommendations to “retail customers,” defined generally as a natural person or the legal representative of such person, who receives and uses a recommendation from a broker-dealer primarily for personal, family, or household purposes,<sup>9</sup> Rule G-19 applies to “customers” (with an exception to the customer-specific suitability requirement for recommendations to SMMPs).

The amendments to Rule G-19 include two changes designed to harmonize MSRB requirements with Regulation Best Interest. These changes are discussed below.

i. Rule G-19 Will Not Apply to Recommendations Subject to Regulation Best Interest

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<sup>8</sup> Rule G-48(c).

<sup>9</sup> See 17 CFR 240.15l-1(b)(1).

As noted above, Regulation Best Interest addresses generally the same conduct that is addressed by Rule G-19 but employs a best interest, rather than a suitability, standard. In order to reduce the potential for duplicative regulation, the amendments add new text to Rule G-19 stating that Rule G-19 does not apply to recommendations subject to Regulation Best Interest. Rule G-19 will thus apply only to:

- Recommendations to customers that are not “retail customers,” as defined by Regulation Best Interest, and
- Recommendations to any customers by bank dealers.

Regulation Best Interest defines a retail customer as a natural person, or the legal representative of such natural person (regardless of net worth), who receives a recommendation from a broker-dealer and uses that recommendation primarily for personal, family, or household purposes. Accordingly, if the dealer making a recommendation is subject to Regulation Best Interest, Rule G-19 will not apply when the dealer makes a recommendation to such persons.

#### ii. The Control Element of Rule G-19’s Quantitative Suitability Obligation Will be Eliminated

Rule G-19’s quantitative suitability obligation, which requires a dealer to have a reasonable basis for believing that a series of recommended transactions are not excessive and unsuitable for the customer when taken together in light of the customer’s profile, has applied only if the dealer has actual or *de facto* control over the customer’s account.<sup>10</sup> In contrast, the quantitative care obligation of Regulation Best Interest applies regardless of whether the broker-dealer exercises actual or *de facto* control over the customer’s account.<sup>11</sup> In the Regulation Best Interest Adopting Release, the Commission stated:

[I]mposing the quantitative care obligation without a “control” element would provide consistency in the investor protections provided to retail customers by requiring a broker-dealer to always form a reasonable basis as to the recommended frequency of trading in a retail customer’s account – irrespective of whether the broker-dealer “controls” or exercises “de facto control” over the retail customer’s account. This

<sup>10</sup> Rule G-19, Supplementary Material .05(c).

<sup>11</sup> See 17 CFR 240.15l-1(a)(2)(ii)(C); see also Regulation Best Interest Adopting Release, 84 FR at 33327.

would also be consistent with the other obligations of the Care Obligation, which apply regardless of whether a broker-dealer “controls” or exercises “de facto control” over the retail customers’ account.<sup>12</sup>

For the same reasons, the amendments to Rule G-19 eliminate the control element of the quantitative suitability obligation prescribed in Supplementary Material .05(c) of Rule G-19.

## 2. Rule G-48

Rule G-48(c) provides that a dealer making a municipal securities recommendation to an SMMP does not have any obligation under Rule G-19 to perform a customer-specific suitability analysis. An SMMP is defined in Rule D-15 by three components:

- The customer must fit within a prescribed category of institutional investor or be a natural person or entity with total assets of at least \$50 million;
- The dealer must have a reasonable basis to believe that the customer is capable of evaluating investment risks and market value independently; and
- The customer must make certain affirmations regarding the exercise of independent judgment and access to information.

As a result of this definition, a dealer making a recommendation to a natural person with at least \$50 million in assets and who otherwise meets the definition of SMMP, would be required by Rule G-19 to conduct reasonable basis and quantitative suitability analyses but not a customer-specific suitability analysis.

In contrast, Regulation Best Interest applies when a broker-dealer makes a recommendation to a “retail customer.” A “retail customer” is a natural person or the legal representative of such natural person (regardless of net worth) who receives a recommendation from a broker-dealer and uses that recommendation primarily for personal, family, or household purposes.<sup>13</sup> Whenever Regulation Best Interest applies, it applies in full; there is no exception from the customer-specific care obligation for high-net worth individuals.

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<sup>12</sup> Regulation Best Interest Adopting Release, 84 FR at 33384 (citation omitted).

<sup>13</sup> 17 CFR 240.15I-1(b)(1).

As described above, pursuant to the amendments, Rule G-19 will not apply to recommendations subject to Regulation Best Interest. Accordingly, the amendments to Rule G-48(c) state that the exception from the customer-specific suitability requirement is available only when a recommendation is subject to Rule G-19 and not Regulation Best Interest.

### **C. Non-Cash Compensation**

Rule G-20(g) broadly prohibits dealers and their associated persons from directly or indirectly accepting or making payments or offers of payments of any non-cash compensation in connection with the sale and distribution of a primary offering of municipal securities, subject to certain limited exceptions. Described generally, these exceptions are:

- Gifts that do not exceed \$100 per individual per year and are not preconditioned on achievement of a sales target;
- Occasional gifts of meals or tickets to theatrical, sporting, and other entertainments, provided that such gifts are not so frequent or so extensive as to raise any question of propriety and are not preconditioned on achievement of a sales target;
- Payment or reimbursement by offerors (generally, the issuer and any advisors to the issuer, the underwriters, and their affiliates) in connection with training or education meetings, subject to specified conditions, including that the payment is not conditioned on achieving a sales target;
- Internal non-cash compensation arrangements between the dealer and its associated persons, subject to specified conditions including that any non-cash compensation related to a sales contest must be based on the total production of all associated persons with respect to all municipal securities within respective product types distributed by the dealer and credit for those sales must be weighted equally; and
- Contributions by any person other than the dealer to a non-cash compensation arrangement between a dealer and its associated persons, subject to the same conditions for permissible internal non-cash compensation arrangements, described above.

Regulation Best Interest's Conflict of Interest Obligation requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to, among other things, identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited

period of time.<sup>14</sup> As described above, Rule G-20 permits certain sales contests in connection with primary offerings. Accordingly, the amendments to Rule G-20(g) clarify that any non-cash compensation permitted by Rule G-20(g), including any sales contests, must also be consistent with the applicable requirements of Regulation Best Interest.

Additionally, in June 1982, the MSRB published interpretive guidance under Rule G-20 stating that sales contests offered by an underwriter to participating members of a syndicate constitute compensation for services and, therefore, must meet the requirements of the then-current version of Rule G-20.<sup>15</sup> The MSRB is deleting this interpretation from 1982 because, with respect to dealers that make recommendations to retail customers, such sales contests may be inconsistent, depending on the particular facts and circumstances, with the requirements of Regulation Best Interest's Conflict of Interest Obligation, which requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to "[i]dentify and eliminate any 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."<sup>16</sup>

## D. Books and Records

### 1. Rule G-8

Rule G-8 directs dealers to make and keep current specified books and records to the extent they are applicable to a dealer's business. For dealers subject to Exchange Act Rule 17a-3, Rule G-8(f) provides that compliance

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<sup>14</sup> 17 CFR 240.15l-1(a)(2)(iii)(D). The Conflict of Interest Obligation also requires broker-dealers to (1) identify and at a minimum disclose or eliminate all conflicts of interest associated with a recommendation of any securities transaction or investment strategy involving securities to a retail customer; (2) identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for a natural person who is an associated person of a broker-dealer to place the interest of the broker-dealer or such natural person ahead of the interest of the retail customer; and (3) identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations and prevent such limitations and associated conflicts of interest from causing the broker-dealer, or a natural person who is an associated person of the broker-dealer, to make recommendations that place the interest of the broker-dealer or such natural person ahead of the interest of the retail customer. 17 CFR 240.15l-1(a)(3)(A)-(C).

<sup>15</sup> See Rule G-20 Interpretive Guidance, "Authorization of Sales Contests" (June 25, 1982).

<sup>16</sup> See 17 CFR 240.15l-1(a)(2)(iii).



with Exchange Act Rule 17a-3 under the Act will be deemed compliance with Rule G-8, provided that certain records required by Rule G-8 must be maintained in any event. Exchange Act Rule 17a-3 requires broker-dealers to make and keep current specified books and records and provides that for purposes of transactions in municipal securities by dealers, compliance with Rule G-8 will be deemed compliance with Exchange Act Rule 17a-3.<sup>17</sup>

When the Commission adopted Regulation Best Interest, it amended Exchange Act Rule 17a-3 to require broker-dealers to maintain a record of all information collected from and provided to a retail customer pursuant to Regulation Best Interest, along with the identity of each natural person who is an associated person, if any, responsible for the account.<sup>18</sup> The Commission also adopted a related requirement for broker-dealers to provide retail investors with Form CRS<sup>19</sup> and amended Exchange Act Rule 17a-3 to require broker-dealers to maintain a record of the date each Form CRS was provided.<sup>20</sup>

Because dealers may comply with Exchange Act Rule 17a-3 for purposes of transactions in municipal securities by complying with Rule G-8, the MSRB amended Rule G-8 to include requirements that parallel the new Exchange Act Rule 17a-3 requirements relating to Regulation Best Interest and Form CRS.

## 2. Rule G-9

Rule G-9 prescribes the periods of time that records must be preserved by dealers. Similar to Rule G-8, Rule G-9 provides that dealers who are subject to and comply with Exchange Act Rules 17a-3 and 17a-4 under the Act will be deemed to comply with Rule G-9, provided that certain specified records are preserved for the applicable time periods specified in Rule G-9 in any event. Exchange Act Rule 17a-4 sets forth record preservation requirements for broker-dealers and, like Exchange Act Rule 17a-3, provides that for purposes of transactions in municipal securities by dealers, compliance with Rule G-9 will be deemed compliance with Exchange Act Rule 17a-4.

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<sup>17</sup> 17 CFR 240.17a-3.

<sup>18</sup> 17 CFR 240.17a-3(a)(35).

<sup>19</sup> 17 CFR 240.17a-14.

<sup>20</sup> 17 CFR 240.17a-3(a)(24).

The Commission amended Exchange Act Rule 17a-4 to require broker-dealers to retain the records related to Regulation Best Interest and Form CRS described above, as well as a copy of each Form CRS for six years.<sup>21</sup> Accordingly, the MSRB amended Rule G-9 to include parallel requirements.

Questions about this notice may be directed to Jake Lesser, Associate General Counsel, or David Hodapp, Director, Market Regulation, at 202-838-1500.

June 26, 2020

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## Text of Amendments\*

### Rule G-8: Books and Records to be Made by Brokers, Dealers and Municipal Securities Dealers and Municipal Advisors

(a) *Description of Books and Records Required to be Made.* Except as otherwise specifically indicated in this rule, every broker, dealer and municipal securities dealer shall make and keep current the following books and records, to the extent applicable to the business of such broker, dealer or municipal securities dealer:

(i) – (x) No change.

(xi) *Customer Account Information.* A record for each customer, other than an institutional account, setting forth the following information to the extent applicable to such customer:

(A) – (E) No change.

(F) information about the customer obtained pursuant to rule G-19 or, for a retail customer, as defined in Rule 15l-1(b)(1) under the Act (“Regulation Best Interest”), to whom a recommendation of any securities transaction or investment strategy involving municipal securities is or will be provided, a record of all information collected from and provided to the retail customer pursuant to Regulation Best Interest, as well as the identity of each natural person who is an associated person, if any, responsible for the account. The neglect, refusal, or inability of the retail customer to provide or update any information described in this paragraph shall excuse the dealer from obtaining that required information;

(G) – (M) No change.

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<sup>21</sup> 17 CFR 240.17a-4(e)(5), (e)(10).

\* Underlining indicates new language; strikethrough denotes deletions.

(xii – xxvi) No change.

(xxvii) A record of the date that each Form CRS was provided to each retail investor, as defined in Rule 17a-14 under the Act, including any Form CRS provided before such retail investor opens an account.

(b) – (h) No change.

## Supplementary Material

No change.

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## Rule G-9: Preservation of Records

(a) Records to be Preserved for Six Years. Every broker, dealer and municipal securities dealer shall preserve the following records for a period of not less than six years:

(i) – (iv) No change.

(v) the records concerning suitability or Rule 15l-1(b)(1) under the Act (“Regulation Best Interest”) required to be maintained pursuant to Rule G-8(a)(xi)(F), until at least six years after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated; and the records concerning Form CRS required to be maintained pursuant to Rule G-8(a)(xxvii) and a copy of each Form CRS, until at least six years after such record or Form CRS is created;

(vi) the customer complaint records described in rule G-8(a)(xii);

(vii) if such broker, dealer or municipal securities dealer is subject to rule 15c3-1 under the Act, the general ledgers described in paragraph (a)(2) of rule 17a-3 under the Act;

(viii) the record, described in rule G-27(b)(ii), of each person designated as responsible for supervision of the municipal securities activities of the broker, dealer, or municipal securities dealer and the designated principal's supervisory responsibilities, provided that such record shall be preserved for the period of designation of each person designated and for at least six years following any change in such designation;

~~(viii)~~ (ix) the records to be maintained pursuant to rule G-8(a)(xvi); provided, however, that copies of Forms G-37x shall be preserved for the period during which such Forms G-37x are effective and for at least six years following the end of such effectiveness;

(ix) the records regarding information on gifts and gratuities and employment agreements required to be maintained pursuant to rule G-8(a)(xvii);

(xi) the records required to be maintained pursuant to rule G-8(a)(xviii);

(xii) the records concerning secondary market trading account transactions described in rule G-8(a)(xxiv), provided, however, that such records need not be preserved for a secondary market trading account which is not successful in purchasing municipal securities;

(xiii) the records required to be maintained pursuant to rule G-8(a)(xxv);

(xiv) the records required to be maintained pursuant to rule G-8(a)(xxvi); and

(xv) the records required to be maintained pursuant to Rule G-8(g)(iii).

(b) *Records to be Preserved for Four Years.* Every broker, dealer and municipal securities dealer shall preserve the following records for a period of not less than four years; provided, however, that each municipal securities dealer that is a bank or subsidiary or department or division of a bank shall preserve the following records for a period of not less than three years:

(i) – (v) No change.

(vi) the customer account information described in rule G-8(a)(xi), provided that records showing the terms and conditions relating to the opening and maintenance of an account shall be preserved for a period of at least six years following the closing of such account and records required by rule G-8(a)(xi)(F) relating to rule G-19 and Regulation Best Interest shall be preserved for a period of not less than six years after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated;

(vii) – (xvii) No change.

(c) – (k) No change.

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### **Rule G-19: Suitability of Recommendations and Transactions**

A broker, dealer or municipal securities dealer must have a reasonable basis to believe that a recommended transaction or investment strategy involving a municipal security or municipal securities is suitable for the customer, based on the information obtained through the reasonable diligence of the broker, dealer or municipal securities dealer to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity

needs, risk tolerance, and any other information the customer may disclose to the broker, dealer or municipal securities dealer in connection with such recommendation.

This rule shall not apply to recommendations subject to Regulation Best Interest, Rule 15l-1 under the Act.

## Supplementary Material

**.01-.04** No change.

**.05 Components of Suitability Obligations.** Rule G-19 is composed of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability.

(a) – (b) No change.

(c) Quantitative suitability requires a broker, dealer or municipal securities dealer ~~who has actual or de facto control over a customer account~~ to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule G-19. No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a broker, dealer or municipal securities dealer has violated the quantitative suitability obligation.

**.06** No change.

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## Rule G-20: Gifts, Gratuities, Non-Cash Compensation and Expenses of Issuance

(a) – (f) No change.

(g) *Non-Cash Compensation in Connection with Primary Offerings.* In connection with the sale and distribution of a primary offering of municipal securities, no broker, dealer or municipal securities dealer, or any associated person thereof, shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation. Notwithstanding the foregoing and the general limitation of section (c) of this rule, the following non-cash compensation arrangements are permitted, provided that they are consistent with the applicable requirements of Regulation Best Interest, Rule 15l-1 under the Act:

(i) – (v) No change.

## Supplementary Material

No change.

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**Rule G-48: Transactions with Sophisticated Municipal Market Professionals**

A broker, dealer, or municipal securities dealer's obligations to a customer that it reasonably concludes is a Sophisticated Municipal Market Professional, or SMMP, as defined in Rule D-15, shall be modified as follows:

(a) – (b) No change.

(c) *Suitability.* When making a recommendation subject to Rule G-19 and not Regulation Best Interest, Rule 15l-1 under the Act, a ~~The~~ broker, dealer, or municipal securities dealer shall not have any obligation under Rule G-19 to perform a customer-specific suitability analysis.

(d) – (e) No change.