

## Private Equity Regulatory Update

January 29, 2021

### Rules and Regulations

- IRS Finalizes Carried Interest Regulations

### Industry Update

- SEC Division of Examinations Statement on Recent and Upcoming Regulation Best Interest Examinations

## Rules and Regulations

### IRS Finalizes Carried Interest Regulations

The IRS has issued final regulations on the taxation of carried interest under Section 1061 of the tax code. Section 1061 was added to the tax code as part of the 2017 tax reform legislation and generally provides that capital gain allocated under certain carried interest arrangements is eligible for the favorable 20% U.S. federal income tax rate only if the underlying asset was held for more than three years at the time of sale. Davis Polk has published a [Client Alert](#) discussing the final regulations.

## Industry Update

### SEC Division of Examinations Statement on Recent and Upcoming Regulation Best Interest Examinations

On December 21, 2020, the recently renamed Division of Examinations (“DOE,” formerly the Office of Compliance Inspections and Examinations) released new guidance regarding its upcoming examination program and priorities with respect to Regulation Best Interest (“**Regulation BI**” or the “**Regulation**”), which was adopted on June 5, 2019.

Regulation BI introduced a new, elevated standard of care that requires broker-dealers to act in the best interest of retail customers when making recommendations to such customers. Following the Regulation BI compliance date of June 30, 2020, DOE staff undertook preliminary examinations to determine whether firms had developed and instituted policies and procedures reasonably designed to comply with the procedural and substantive requirements of Regulation BI.

Based on those initial assessments, DOE staff intend to broaden the scope of their Regulation BI examination program in 2021 to (1) focus on the Regulation’s specific requirements, particularly those that require broker-dealers to have a reasonable basis to believe that a recommendation is in the best interest of the customer and (2) undertake more rigorous transaction testing to determine whether broker-dealers have effectively implemented their Regulation BI policies and procedures.

Accordingly, DOE staff has advised that the following components of Regulation BI will be prioritized in the next phase of examinations, beginning in January 2021:

- **Continued evaluation of firm policies and procedures**, including evaluating specific firm processes for compliance with Regulation BI, and alterations to firm product offerings (e.g., the removal of higher cost products when lower cost products are available).

- **Evaluation of how firms have considered costs in making a recommendation**, which may include a review of the information that is available to firm personnel to identify relevant costs, how any such information has been used by firm personnel and any documentation relating to the consideration of costs.
- **Evaluation of the processes firm personnel have used to make recommendations to new customers**. As an example, if a firm recommended a rollover from an employee benefit plan, examiners will assess what information was gathered from new customers, what disclosures were made at the time, how alternatives were considered and what documentation was retained.
- **Evaluation of the processes firm personnel have used to recommend complex products**, including a review of the information that was available and used to consider reasonably available alternatives.
- **Evaluation of the processes that firms have used to identify and address conflicts related to recommendations**.

The DOE staff also announced that it will be conducting “enhanced transaction testing” to determine whether broker-dealers have effectively implemented their written policies and procedures. Given this guidance, DOE staff encourages broker-dealers to evaluate their processes and practices, “in particular, to consider whether the initial programs adopted by the June 30, 2020 compliance date are, in practice, reasonably designed to achieve compliance with Regulation Best Interest.”

- [See a copy of the statement](#)

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