Take a Deep Dive into the SEC's Investment Advice Rule Package

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Editor's note: The following is an edited transcript of a July 18 FPA webinar on the SEC's investment advice rule package. The new rules, which were first proposed in 2018 and passed by the SEC in June, go fully into effect June 30, 2020. One part of the four-part package in particular—Regulation Best Interest, or Reg BI—will greatly impact how retail consumers receive financial advice. This edited transcript explores Reg BI, as well as the other elements of the rule package. FPA members can access an on-demand recording of the webinar at Learning.OneFPA.org. FPA will provide members additional webinars and resources on the SEC rule package through its Member Advisory Council (MAC).

For over 80 years, Congress and regulators have struggled to determine the appropriate standard of care for individuals and entities that make financial recommendations to individuals. Today, when we think about Reg BI, the Department of Labor's new fiduciary rules, state fiduciary initiatives, and the CFPB's rules that are coming online next year, they're all part of the same ecosystem.

In terms of context, what it's all trying to get at is how retail investors learn about investments. And there are four factors: (1) there's a fear that salespeople are going to mislead individuals; (2) there's a fear that people are going to prefer free advice versus paying for advice (commissions versus an AUM fee); (3) there's a fear that people are going to have worse outcomes if they don't actually get advice (we don't want rules structured to discourage people from getting advice); and (4) there's a fear that more complex rules could reduce financial innovation.

You might be thinking, "This conversation has been going on as long as I've been working," but in reality, it's been going on a lot longer than that. If you look at the transcripts of the hearings for the Investment Advisers Act of 1940, a lot of those discussions are the same ones we've been having the last couple of years about commissions and standards of care. We're seeing more action from the SEC right now, because other regulators and individual states have started to get involved, seeking to regulate the same [fiduciary] areas.

A key takeaway is: this is the beginning or even the middle; it is not the end. It's important to keep in mind that this is going to continue to evolve. Reg BI and related guidance is at the center of the conversation, but don't lose sight that the landscape is going to keep changing. The standard of care for retail customers is something that will always be a focal point for regulators.

To us, this is the next page in an 80-year focus on how to balance the tension between the incentives that are created by a commission structure versus the desire to have a high standard of care, and the desire to provide retail customers with access and advice that they might not otherwise get. Even now, the [SEC rule] package is already changing. The House has voted to defund it, although it's unlikely that will have any impact. States will continue to act. There's also next year's election. If there are different victors, we could see different agendas being moved forward.

Understanding the Rule Package

The SEC's new rule package was adopted on June 5 by a three-to-one vote. It's comprised of four rules:

1. **Form CRS** relationship summary is a lot like Form ADV; it's an initial disclosure to customers.
2. **Investment adviser interpretation** largely restates and consolidates prior guidance related to advisers.
3. **Solely incidental interpretation** relates to the type of monitoring and the type of services that a broker can provide while still relying on the broker-dealer exclusion to investment adviser status.
4. **Regulation Best Interest**, or Reg BI, which has been the focus point for most people, is a new standard of care for broker-dealers.

For Reg BI, the compliance date is June 30, 2020, so we are under a year away. At this point, it likely makes sense to begin taking steps to develop a compliance strategy, because these rules are coming into effect.

According to SEC Chairman Clayton, the rule package had four consumer-level goals and one industry-type goal. First, from the consumer level, the SEC wants to require that recommendations are in the investor's best interest. Second, as a transition from traditional SEC guidance where disclosure is a solution for most problems, with this new rule they've indicated that disclosure isn't always going to be sufficient. So, mitigation or elimination of conflict is an element here.

Additionally, they want to make it more clear to investors about the scope and type of relationship they have with the individual providing recommendations or advice. This is an area that has received a lot of attention in recent years with the proliferation of the term "adviser" where it's been used by everything from brokers to RIAs to insurance folks. The last consumer-related element is enhanced disclosure of material conflicts.

At the same time, the SEC is trying to balance these [consumer-focused] aims with still allowing broker-dealers and RIAs to have their different business models and traditional forms of compensation; in other words—commissions.

Regulation Best Interest (Reg BI)

Kevin: There are five key components of Reg BI. First, it imposes a best interest standard of conduct. Then, it goes on to say that if you are going to meet that best interest standard of conduct, you also need to satisfy four obligations: (1) the care obligation; (2) the disclosure obligation; (3) the conflict of interest obligation; and (4) the compliance obligation. Before we walk through each obligation, let's unbundle the standard of conduct.

Reg BI is about having brokers act in the best interest of:

- the *retail customer*,
- at the time the recommendation is made,
- without placing their interest ahead of that of the retail customer.

First, we need to know who a retail customer is. Second, we're going to want to figure out when this obligation applies. (The rule says, "at the time the recommendation is made." It's essentially a forward-looking, point-in-time code of conduct. For RIAs, the standard of care is usually more of an ongoing obligation versus a point-in-time obligation.) And then, I've got to do that without placing my financial or other interests ahead of the interests of the retail customer.

If you listen to different consumer groups, different commissioners, different lawyers—everyone is all over the map on what it means to not place your interest ahead of that of your customer. We're taking it at face value for now. The standard of care will ultimately be decided by courts; they'll interpret it. It will ultimately be decided by other regulators. FINRA will probably play a role in how this develops. But what the SEC seems to be saying is, "We think this is a really high standard. We think it's a lot like DOL's impartial conduct standards. We think it's largely what [Section] 913(g) of Dodd Frank would have required."

David: There were a lot of comments about the Department of Labor's standards [at the time] that it wasn't workable in some situations. Recognizing that different agencies have different perspectives, the SEC here was trying to balance it all and come up with something that established some rules that could be workable across the spectrum. I believe their intent is to come up with a workable solution. That's why there's agreement from some, but not all, industry groups that it's workable, but, again, we have to see where it proceeds from here.

Kevin: I really do think it's going to depend on how it's interpreted by courts, before we know what the best interest standard ultimately imposes.

So now that we've described what the standard is, we've got to figure out when it has to be applied. It has to be applied when you're making recommendations as a broker-dealer to a retail customer. So who are retail customers?

The shorthand is, if a broker is recommending something to an individual, and that individual is acting in a professional capacity (like as a broker or RIA themselves), or they're acting on behalf of their employer to invest treasury resources or to figure out what investment options to include in their corporation's 401(k) plan, then the recommendation is not subject to Reg BI.

But if the individual is acting on their own behalf, on behalf of their family, on behalf of their IRA, or on behalf of their own account balance inside a retirement plan, then they are a retail customer. The motivation seems to play a big role and whether or not it's an individual involved. If it is to an entity—if you're giving a recommendation to a giant bank—pretty safe to say you're out [this is not a retail customer]. If you're giving a recommendation to David here, pretty safe to say you're in [this is a retail customer].

David: I think that clears up some of the questions that came up in the [SEC rule package] proposal. Take retirement, for example. The plan itself is not a retail customer, but an individual in the plan—possibly getting advice on an individualized basis—could be a retail customer. So in your practices, when you look at areas where there's an institutional portion combined with a retail portion, it's important to keep in mind exactly what portion of the relationship you are serving.

Kevin: One other thing to note is that a lot of industry commenters had asked the SEC to say that an individual who has more than $50 million to invest should not be considered a retail customer. The SEC didn't take that. So no matter how wealthy an individual may be, if they're saving for household purposes, they're a retail customer.

Now, David hinted at retirement. Under former guidance, in order to be subject to FINRA's rules or the different standards of care that were in place then, an account recommendation had to be bundled with a buy/sell recommendation in order to be covered. Here, the SEC said explicitly, account recommendations—whether to roll over, whether to open an account, what type of an account to open—are expressly "in," even if there's no linked recommended securities transaction. That significantly broadens the scope of a lot of the suitability rules, and combining with the best interest standard, that's a significant change.

The last big change before we get into the components is implicit "hold" recommendations. This was something that came up in the final rule that hadn't been present in the prior rule. The SEC made clear that hold recommendations are subject to Reg BI, and that by being silent, a broker-dealer can be deemed to have made an implicit hold recommendation in certain circumstances. If I say to David, "Every quarter, I'm going to look at your account and see if there are changes that you should make," and then I don't call David for two quarters, I'm deemed to have given him a hold recommendation as of the date that I was supposed to provide my monitoring.

How to Meet the Best Interest Standard

Kevin: In order to meet the best interest standard, you need to satisfy four component obligations. We'll compare what the prior rules were to how things have changed in light of the SEC's action.

Care obligation. A handful of changes here are worth paying attention to. The first is that [FINRA's suitability rules] used "suitable." Reg BI uses "best interest." Some of the FINRA guidance had described the broker standard as requiring them to not place their interest ahead of the customer's, so it might not be a big change, but again, it's going to take some time for courts to shake it out.

The second is, when I look at reasonable basis suitability and customer basis suitability [in the language of the SEC's care obligation], both now expressly include cost. I'm not sure if you could meet your suitability obligation without considering cost in the past, but at least moving forward, the SEC has made clear you can't.

The third change is that quantitative suitability used to turn on whether or not you had control over an account. The SEC has made it so that quantitative suitability applies even if you're just making recommendations.

And lastly, the SEC has said that you can't meet this care obligation through disclosure alone (there are other obligations that really get at that). Overall, this should look familiar to what brokers have been working with, so it's probably not too tough to develop policies and procedures to meet these new changes.

David: There's this ongoing debate: does this just match suitability or not? The view among many folks is that this is not just suitability; it is beyond suitability now. That's something you should be watching for when you're thinking about your compliance. Many of you may rely on someone else to do a lot of your compliance work, so that's the question to ask: how are we interpreting this compared to our existing suitability framework?

Kevin: A couple of other things to keep in mind about the care obligation: the SEC has really expanded on what a retail customer's investment profile is. When a broker-dealer is giving advice or making recommendations to a retail customer, they are expected to have knowledge about a certain number of factors, and they're encouraged to have information about other factors.

You should try to get the age of your retail customer, know their other investments, understand their financial situation and needs, understand their tax status, understand their investment objective, understand their investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer might disclose. Most of these are common sense, but I thought it was very interesting that the SEC added, "You should consider any other information the retail customer might disclose." It could make it tougher to design a compliance program that's check-the-box; it could require more of a personalized approach.

David: I could see a lot of the tools already being used built out to automate this to make compliance more practical. I think there's a technological solution for this.

Kevin: The SEC also provided some insight into ways to fail the care obligation. If you're making a recommendation to maximize your own compensation, that's not putting the retail customer's interest ahead of yours. If you're making a recommendation to win a sales contest, or to satisfy firm sales quotas, or to meet other performance targets, that wouldn't be best interest.

David: It's important to keep that in mind, because we've gone through a bunch of yo-yoing here. Prior to the Department of Labor's fiduciary rule, a lot of folks had a lot of programs like this in place, and some of them have come back. The question is, do your sales quotas or sales contests relate to a specific product? If you sell a specific product, does that lead to you getting compensated more in an incentivized way? Again, the slightly differing views of where the lines are, are going to come into play.

Kevin: The last item on the care obligation is, the SEC has said, if you're recommending a rollover, in addition to all the factors we've told you to consider, you should consider a couple of other things. You should consider fees and expenses. You should consider the level of services available, the availability of investment options, the ability to take penalty-free withdrawals, the required minimum distribution rules, protection from creditors and legal judgements, the holding of employer stock, and other special features.

Disclosure obligation. The disclosure obligation is largely cataloging prior guidance that came from rule 10b-10 or out of case law, and it was largely designed to avoid having brokers mislead individuals and to make sure consumers have sufficient facts to understand what is being recommended.

Prior to, or at the time of, recommendation, you've got to furnish your retail customer with the description of all the material facts related to the scope in terms of the relationship, as well as all material facts relating to conflicts of interest that are associated with the recommendation.

A material fact is one where there's a substantial likelihood that a reasonable retail customer would consider it important. This leaves brokers on their own to figuring out what rises to that level.

The SEC doesn't prescribe any specific form of disclosure. You can do it as a single document; you can do it as multiple documents; you can provide it prior to your recommendation. In some circumstances, you might only be able to provide it orally, in which case you can supplement it in writing afterward.

The SEC is calling it a layered approach to disclosure. The idea is that, if a customer wants additional information, they're able to get it from the broker. But for customers who just want the basics, there's at least a bare-bones summary upfront that allows them to understand the situation they're getting into.

The other thing that's important is understanding what's a conflict. Here, the SEC provided some insight. A conflict is any interest that might incline a broker-dealer or other natural person, consciously or unconsciously, to make a recommendation that's not disinterested.

As examples, the SEC says proprietary products, products sponsored by affiliates, if you have a limited investment menu, if you have multiple share classes available and one pays more, if you're recommending securities that are underwritten by your firm or by an affiliate, and if you have to allocate investment opportunities between your customers—those are examples of conflicts. Much like the rest of the rule, the SEC tried not to be prescriptive, and instead leaves it on brokers to understand the framework and develop systems internally.

One of the other elements here is the scope in terms of the relationship. If you're a pure broker-dealer or you're a pure RIA, when you provide your Form CRS, your customer's going to understand your capacity. If you're a dual registrant, you need to supplement your Form CRS with a disclosure explaining the capacity that you're giving the recommendation in at this point.

Also, under Regulation Best Interest, going forward, if you're acting as a broker and you're calling yourself an adviser "er" or an advisor "or," in most cases the SEC would consider your communication to be misleading. This was something that got a lot of attention from the broker-dealer community because, for the past 25 years, "adviser" has become a preferred term for anyone making recommendations to retail customers. It's going to be interesting to see how this shakes out.

Conflict of interest obligation. The conflict of interest obligation applies to the broker-dealer firm versus applying directly to the individuals who are associated with the broker-dealer. It imposes an obligation on the broker-dealer entity to establish, maintain, and enforce policies and procedures related to conflicts. These go significantly beyond prior guidance.

First, it's designed to provide flexibility. It's a focus on policies, not on outcomes. The idea is that brokers will devote most of their resources to the conflicts that provide the greatest harm or that pose the most risk to retail customers.

Another key point here is they say, "reasonably designed to …" They're not expecting perfection. They're expecting that thought goes into it, and that this be an iterative process where as conflicts are discovered, as harm is discovered, these get updated.

Some conflicts can be disclosed, some can be mitigated, and some are just problematic. If the conflict is at the broker-dealer entity level, those seem to be disclosure-type conflicts. If it's an incentive to the individual employee—they're getting a commission, employment incentives, or variable compensation—these would require some mitigation.

Then, the SEC created this third category—identify and eliminate. It's a narrow band of conflict. It's sales contests, sales quotas, bonuses, and non-cash compensation based on the sales of specific securities or specific types of securities within a limited period of time.

The SEC described mitigation as positive procedures reasonably designed to reduce the potential effect a conflict may have on a recommendation given to a retail customer. It's something you've done to reduce the impact of the conflict. There's still some gray area. What does "reduce" mean? How much does it have to be reduced? We're going to have to have case law, and we're going to have to have courts figure this out. This is an area where we're likely to see some action over time.

Compliance obligation. The SEC also added a stand-alone compliance obligation. This falls solely on the broker-dealer entity, and not on the individuals. What the SEC is saying is, in addition to satisfying the three obligations, there's a general obligation that you need to have policies and procedures—and enforce them—that are designed to achieve compliance with the other obligations.

Depending on the size and complexity of the firm, you should have controls, you should have procedures for remediating noncompliance, you should have training, and, periodically, you should review what you're doing to see if it works and test it to make sure that there aren't weaknesses.

Investment Adviser Standard

Kevin: In terms of investment advisers, the SEC issued one piece of guidance that went to the dual duties of care and loyalty. This guidance consolidated guidance from a number of other releases and case law.

Duty of care. The duty of care requires that an investment adviser act in the best interest of the client. To do this, the adviser has to make a reasonable inquiry into the client's financial situation, financial sophistication, investment experience, and investment objectives. It's very similar language to Reg BI. You have a duty to seek best execution, and you have a duty to provide advice and monitoring.

Duty of loyalty. The duty of loyalty means that you've got to act in your client's interest. Typically with an investment adviser, if you disclose a conflict and get consent after a full and fair disclosure, that conflict can be essentially waved. The client is allowed to allow you to act in a conflicted manner.

Here, the SEC said, some conflicts are very complicated, and some retail customers are very unsophisticated. If you find yourself in a situation where the investor is not going to totally understand the conflict—they won't be able to make an informed consent—then you must mitigate or eliminate that conflict, at least to the degree where the investor can then provide informed consent.

Advisers have traditionally had a kind of back door for getting consent for conflicts, and this represents somewhat of a stiffening of that ability to use the escape hatch.

Form CRS

Kevin: Form CRS is going to be structured as another part of Form ADV. It's going to be a two-page document that you're going to give to customers at the onset of the relationship. It's going to be structured as a Q&A, and the focus is on readability. It's going to provide very basic information to your customer (or potential customer) about the services you provide, the scope of the relationship, the fees and cost, and the applicable standard of conduct.

One thing that's been misperceived in the press lately has been over the use of the term "fiduciary." In the proposed rule package, investment advisers had form language they had to include that said, "We're fiduciaries." That [language] came out [of the final rule]. If you're an investment adviser now and you're using the form and you're doing your Q&A, you can say you're a fiduciary. You're allowed to, but it's not mandated anymore.

Also, if you're a broker and you're acting as a broker, calling yourself a fiduciary is likely to be viewed as misleading by regulators. That's a significant change. I think one thing that's been a focus for the SEC and other regulators has been investor confusion over who actually is a fiduciary and who's not.

Form CRS is designed to get the standard of care across. If you're a dual registrant, you're going to provide something that says, "Sometimes I'm a fiduciary, sometimes I'm not a fiduciary. Sometimes I'm an RIA, sometimes I'm not an RIA," and that could be confusing for customers when it turns out you're acting in your broker-dealer capacity.

Commenters generally were critical of Form CRS as it was initially proposed. As a result, the SEC heavily revised it. We'll have to wait and see if it ends up being helpful.

Solely Incidental Exclusion for Broker-Dealers

The last piece of this rule package—and it is a new piece—is interpretative language about the solely incidental exclusion for broker-dealers from registered investment adviser status. If you're a broker-dealer and your primary business is affecting the securities transactions, you're allowed to make recommendations, if they're designed to encourage securities transactions. If you're providing recommendations for some other reason, that doesn't work.

And, you can only provide certain types of recommendations. The example the SEC provided was discretion. You're not providing recommendations, you're not effectuating securities transactions if your primary business is managing someone's investment account. The SEC is saying, if you have unbounded discretion; if you're managing someone's account for an open-ended period, you're not acting as a broker-dealer. Go register as an RIA.

They also said you can't offer continuous monitoring if you're a broker. It makes clear that the distinction between the two is RIAs have an ongoing obligation to look at the account. Brokers periodically evaluate whether it would be in a customer's best interest to engage in securities transactions.

Questions from FPA Members

Can individual states put in place more strict regulations than the SEC? For example, Nevada?

Kevin: I think the industry was hoping the SEC would say, "Our rules preempt state rules." The SEC didn't say that. They said it's up to the courts to figure out if this preempts.

When I look at some of the state rules that require brokers to provide ongoing monitoring or require brokers to say that they're fiduciaries, it creates a situation where there could be a direct conflict with the SEC. Now, preemption is a thorny topic. I don't want to guess what states are going to do, but it really tees-up a fight.

David: Look at New Jersey. Other states are now pattern-matching what New Jersey has done. They're trying to write around the SEC's Reg BI package to come up with provisions that aren't specifically addressed, and a lot of that is designed to address preemption.

Whenever you have a Democratic administration, red states write around them. Whenever you have a Republican administration, blue states write around them, and that's part of what's going on. This is going to fight itself out in court.

Kevin: After seeing the Department of Labor's fiduciary rule go down in flames in the courts, the SEC seems to have been pretty cautious about trying to protect its rule package from legal challenges, and asserting preemption might have provided an opening for some blue state attorney generals.

For a dual-registered individual, how are top producer trips viewed?

Kevin: This is something we went through with the Department of Labor's fiduciary rule, and these top producer trips are something that firms don't like getting rid of. I think there's necessarily going to be a fair amount of compliance, a fair amount of oversight, and a fair amount of changes to the structure of these trips. That being said, I don't think there's a blanket ban on them. There's always going to be arguments that firms should provide additional training, that there are benefits to these programs, and that some level of interest for distribution is permissible.

If I charge 1 percent in AUM each year, that's 10 percent over 10 years. If I do a one-time commission of 3 percent, that's 3 percent over 10 years. Does this regulation say one is bad and one is good?

Kevin: This is a great question. It's something that had different voices screaming at different times during the proposal phase, during the fiduciary rule, and when the SEC was doing rule-making in the mid-2000s. It's an issue that keeps coming back, and it relates to the SEC's new element that when you make an account recommendation, it's covered by Reg BI.

If you're a broker and you recommend a commission-based account, or you're a broker and you recommend someone open an AUM-based account, you've got to make a best-interest recommendation of account type. If it's clearly better for someone to go to an AUM account versus a commission account, or clearly better the other way, Reg BI's obligations are going to push you to recommend the better type of account for that person. ■