

The Impact of the SEC's Standards of Conduct Rulemaking Package on Investment Advisers

Why did the SEC issue these rules and what's in the package?

The SEC has spent almost two decades thinking about how to raise the legal standard brokers owe their individual customers. This rulemaking is a culmination of that thinking. It has four parts – a new standard for brokers (Regulation Best Interest, or Reg BI), a new disclosure requirement for brokers and advisers (Form CRS), an interpretation of the advisers' fiduciary duty, and an interpretation of when brokers can provide advice without having to register as advisers (the "solely incidental" interpretation).

What does the interpretation of the fiduciary duty do?

It reaffirms the core principle that advisers must act in their clients' best interest at all times and throughout the advisory relationship. And it reaffirms that advisers have a special relationship of trust and confidence with their clients, which means that they must put their clients' interests first. The interpretation provides guidance on advisers' duties of loyalty and care to their clients.

Do advisers still have to put their clients' interests first?

Yes. The SEC interpretation said that an adviser must not put its own interests ahead of its clients' interests and explained that putting the clients' interests first is a plain English way of stating the duty.

What are an adviser's duties with respect to conflicts of interest?

Advisers must fully and fairly disclose conflicts of interest and ensure that their conflicts do not prevent them from acting in their clients' best interest or otherwise compromise their advice. In some cases, this will require advisers to eliminate conflicts and in others to modify practices to reduce or mitigate conflicts, but advisers always need to identify conflicts, determine how best to manage them, and fully disclose them.

What else must an adviser do under the fiduciary duty?

An adviser also has a duty of care. Under this duty, it must make sure it understands its client's financial situation and investment objectives, understands the products and services it's recommending, and make recommendations that are in the client's best interest. An adviser also has a duty to seek best execution of its client's transactions in order to obtain the most favorable total costs or proceeds for the client under the circumstances. And, assuming this is within the scope of the agreed-upon services, an adviser must provide advice and monitoring at a frequency that is in the client's best interest. The interpretation only explains an adviser's duty of care and loyalty, noting that an adviser has other obligations under the fiduciary duty, including, for example, having a compliance program, voting proxies in a client's best interest, and keeping client confidences. An adviser may also have obligations under relevant state and ERISA law.

Does the interpretation change the fiduciary duty? Does it in any way weaken it?

No. Advisers continue to be fiduciaries and their longstanding fiduciary duty under law and regulation has been reaffirmed by the SEC's interpretation. As fiduciaries, advisers continue to have an affirmative duty of care, loyalty, honesty and utmost good faith to act in the best interest of their clients at all times. The core principles of the fiduciary duty are just as strong following the interpretation.

What should advisers' clients know about the fiduciary duty interpretation?

Advisers' obligations to their clients have not changed. Financial professionals (advisers and brokers alike) should encourage clients to ask good questions and help them to understand the implications of the responses.

What does new Reg BI do?

Reg BI is intended to strengthen brokers' suitability standard by requiring brokers to act in their customers' best interest when they make recommendations about securities to them. It will now require brokers to identify their conflicts and, in some cases, either mitigate them or eliminate them, and also to provide some new disclosures.

Why is the SEC explicitly requiring brokers to mitigate some types of conflicts?

The SEC recognizes that the broker-dealer sales model often creates significant incentives for brokers and their reps to put their own interests' ahead of what's best for their customers. These conflicts make it very difficult, if not impossible, for them to act in their customers' best interest. So these types of conflicts must either be reduced or managed in a way that minimizes their impact. Some conflicts, such as sales contests and quotas, must now be eliminated completely. And brokers will need to have a process in place to reduce incentives for individual reps to act for their own or their firm's benefit rather than their customers' benefit.

Given that specific types of conflicts must be mitigated or eliminated under Reg BI, does that make it a stronger standard than the fiduciary duty?

No. The advisers' fiduciary duty has always been, and will continue to be, the benchmark standard. The main purpose behind Reg BI was to raise the suitability standard and make it closer to the fiduciary standard. But Reg BI does not create a relationship of trust and confidence between brokers and their customers. There are some key differences:

- Reg BI is transaction-based – it only applies to a specific recommendation. The fiduciary duty is overarching. It applies to the entire client relationship and to all the services the client and adviser have agreed to.
- Advisers' disclosures in their Form ADV brochures are broader than those required under Reg BI.
- The conflicts that brokers will now need to mitigate or eliminate were particularly concerning to the SEC and don't typically exist in an advisory relationship. Also, the brokers' mitigation requirement applies only to incentives for their reps and not to the firm's conflicts, whereas all of an adviser's duties, including the duty to make sure that conflicts don't compromise its advice, are at the firm level.
- Brokers' compensation will continue to be tied to transactions, while advisers' fee structures are more closely aligned with their clients' interests.
- Reg BI only applies to recommendations made to individual retail customers. The fiduciary duty applies to relationships with all types of advisory clients, including individuals and institutions.

What will be the impact of Reg BI?

One of the potential negative consequences of Reg BI is that it will lead to even more confusion among investors. Brokers will be able to say that they are acting in their client's best interest, but customers may not understand how limited that obligation is or how severe broker conflicts can be. On the positive side, Reg BI may increase investor protection, but that will depend on how strongly the SEC implements and enforces it.

The SEC says it has incorporated fiduciary principles into Reg BI. Does this mean that brokers can now call themselves fiduciaries?

No. Brokers are not fiduciaries and may not call themselves fiduciaries. If a firm is dually-registered as a broker and adviser, it may call itself a fiduciary with respect to its advisory services. A registered rep may not call himself or herself a fiduciary unless he or she is also supervised by an adviser. Standalone brokers also won't be allowed to include the words "adviser" or "advisor" in their firm name and reps that are not supervised by an adviser will not be able to use those titles.

Are there any new requirements for advisers in the package?

Yes. Investment advisers and broker-dealers will be required to provide clients who are individuals with a new two-page disclosure document called Form CRS (for Client Relationship Summary). On Form CRS, firms will be required to explain their services, professional obligations, disciplinary history and conflicts of interest in a simple question-and-answer format. While this is a totally new requirement for broker-dealers, investment advisers have long been required to make these types of disclosures in a narrative brochure (Form ADV). Beginning in June 2020, advisers will be making those disclosures in the new format along with their brochures and will file the form with the SEC as Form ADV Part 3.

Will the IAA be able to help us with this new Form?

Yes. The IAA has conducted webinars and is developing additional resources to assist members in understanding and complying with the new Form CRS requirements. The IAA has also formed a Form CRS Implementation Working Group, which members are invited to join.