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THE SEC'S INVESTMENT ADVISER INTERPRETATION AND REG BI: THE (PARTIAL) CONVERGENCE FOR RIAs AND BROKER-DEALERS

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SEC Guidance for Broker-Dealers and RIAs

On June 5, 2019, the Securities and Exchange Commission issued four pieces of guidance that will significantly affect investment advisers and broker-dealers:

- Regulation Best Interest: The Broker-Dealer Standard of Conduct (Reg BI)
- Form CRS Relationship Summary; Amendments to Form ADV (Form CRS)
- Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser (Solely Incidental Interpretation)
- Commission Interpretation Regarding Standard of Conduct for Investment Advisers (RIA Interpretation)

The Fiduciary Basis for Best Interest for Broker-Dealers

The release language in the SEC's final Reg BI explains:

*The Commission has crafted Regulation Best Interest **to draw on key principles underlying fiduciary obligations**, including those that apply to investment advisers under the Advisers Act, while providing specific requirements to address certain aspects of the relationships between broker-dealers and their retail customers.*

Overview of Duties Owed

SEC RIA Interpretation	SEC Regulation Best Interest
<p>The SEC’s new guidance (the RIA Interpretation) interprets an investment adviser’s fiduciary duty to include both a duty of care and a duty of loyalty.</p> <p>This combination of the care and loyalty obligations requires an investment adviser to act in the “best interest” of its client at all times.</p>	<p>Regulation Best Interest (Reg BI) requires broker-dealers to act in the best interest of a retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer; and to address conflicts of interest.</p>



Compliance Dates

SEC RIA Interpretation	SEC Regulation Best Interest
<p>The RIA Interpretation reflects the SEC's views about the application of existing rules and does not purport to establish new rules. It was effective on July 12, 2019 and therefore applies at this time.</p>	<p>The Compliance Date for Reg BI is June 30, 2020.</p>

Entities Covered

SEC RIA Interpretation	SEC Regulation Best Interest
<p>The RIA Interpretation applies to both SEC- and state-registered investment advisers.</p>	<p>Reg BI applies to all broker-dealers.</p>

Clients/Customers and Recommendations

SEC RIA Interpretation	SEC Regulation Best Interest
<p>The RIA Interpretation applies to all advice given to all clients.</p>	<p>Reg BI applies to recommendations of securities transactions or investment strategies involving securities to “retail customers.”</p> <p>A retail customer is a natural person, or the legal representative of such natural person, who uses the recommendation primarily for personal, family, or household purposes.</p>

Application to Retirement Plans and Participants

SEC RIA Interpretation

No limitation of the definition of “clients.” Therefore, advice to workplace retirement plans of all types, as well as participants (and other retirement, welfare and education accounts) is subject to an investment adviser’s fiduciary duty.

SEC Regulation Best Interest

Reg BI does not apply its best interest standard to “workplace retirement plans” (except small Keogh plans).

“Plans” include workplace arrangements that provide retirement benefits, including, *e.g.*, deferred compensation plans of state and local governments and tax-exempt organizations under 457, and annuity contracts and custodial accounts under 403(b).

Reg BI covers recommendations about investing in IRAs and individual retirement annuities, SEP IRAs, and SIMPLE IRAs.

“Retail investor” also includes services for tax-favored savings arrangements such as Archer Medical Savings Accounts, Health Savings Accounts, and similar tax-favored health plan saving arrangements, Coverdell education savings accounts and 529 plans.

Duties and Obligations Owed

SEC RIA Interpretation

The RIA Interpretation explains that investment advisers owe these duties:

- Duty of Care:
 - Duty to provide advice that is in the Best Interest of the client
 - Duty to seek best execution
 - Duty to provide advice and monitoring over the course of the relationship
- Duty of Loyalty

SEC Regulation Best Interest

Reg BI imposes the following obligations on broker-dealers and their representatives:

- Disclosure Obligation
- Care Obligation
- Conflict of Interest Obligation
- Compliance Obligation

Duty/Obligation of Care

SEC RIA Interpretation	SEC Regulation Best Interest
<p>The SEC does not define the duty to provide advice that is in the best interest of a client, other than general explanations such as: <i>“Whether the advice is in a client’s best interest must be evaluated in the context of the portfolio that the adviser manages for the client and the client’s objectives.”</i></p> <p>However, it seems likely that the standard would not be lower than the Reg BI requirements for broker-dealers.</p>	<p>Reg BI provides more definition, in relevant part:</p> <p>The broker-dealer and its representative, in making a covered recommendation, must exercise “reasonable diligence, care, and skill” to:</p> <p><i>Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer’s investment profile and the potential risks, rewards, and costs associated with the recommendation”</i></p>

Duty/Obligation of Loyalty and Care

SEC RIA Interpretation

The RIA Interpretation says that an investment adviser “*must, at all times, serve the best interest of its client and **not subordinate its client’s interest to its own.** In other words, the investment adviser cannot place its own interests **ahead of the interests of its client.**”*

SEC Regulation Best Interest

Reg BI requires that broker-dealers and their representatives exercise “*reasonable diligence, care, and skill to . . . **not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer***”

Duty of Care: Account Type

SEC RIA Interpretation

*An adviser's fiduciary duty applies to all investment advice the investment adviser provides to clients, including advice about investment strategy, engaging a sub-adviser, and **account type**.*

In providing advice about account type, an adviser should consider all types of accounts offered by the adviser and acknowledge to a client when the account types the adviser offers are not in the client's best interest.

SEC Regulation Best Interest

Regulation Best Interest will apply to recommendations by a broker-dealer of a securities **account type**.

Thus, the Care Obligation will require a broker-dealer to have a reasonable basis to believe that a recommendation of a securities account type (e.g., brokerage or advisory, or among the types of accounts offered by the firm) is in the retail customer's best interest.

Note regarding dully registered professionals.

Duty of Care: Importance of Costs

SEC RIA Interpretation	SEC Regulation Best Interest
<p>The cost (including fees and compensation) associated with investment advice would generally be one of many important factors—such as an investment product’s or strategy’s investment objectives, characteristics, liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon, and cost of exit—to consider when determining whether a security or investment strategy is in the best interest of the client.</p> <p>Note: Includes advisory fees.</p>	<p>A broker-dealer and its representative must exercise reasonable diligence, care, and skill to:</p> <p>. . . have a reasonable basis to believe that the recommendation is in the best interest of a retail customer based on that customer’s investment profile and the potential risks, rewards, and costs associated with the recommendation.</p>

Duty of Care: Importance of Costs

SEC RIA Interpretation	SEC Regulation Best Interest
<p>When considering similar investment products or strategies, the fiduciary duty does not necessarily require an adviser to recommend the lowest cost investment product or strategy.</p>	<p>The Reg BI standard does not necessarily require the lowest cost option and, while cost is an important factor that always needs to be taken into consideration in making a recommendation, it is not the only one.</p>

Rollover Recommendations

SEC RIA Interpretation	SEC Regulation Best Interest
<p><i>“Advice about account type includes advice about whether to open or invest through a certain type of account (e.g., a commission-based brokerage account or a fee-based advisory account) and advice about whether to roll over assets from one account (e.g., a retirement account) into a new or existing account that the adviser or an affiliate of the adviser manages.”</i></p> <p>Therefore, a rollover recommendation must be in the best interest of the participant.</p>	<p>Reg BI applies to recommendations to open an IRA or to roll over assets into an IRA.</p> <p>The Care Obligation requires a broker-dealer “to have a reasonable basis to believe that the IRA or IRA rollover is in the best interest of the retail customer, taking into consideration the retail customer’s investment profile and other relevant factors, as well as the potential risks, rewards, and costs of the IRA or IRA rollover compared to the investor’s existing 401(k) account. . . .”</p> <p><u>Note:</u> Form CRS and conflict disclosure.</p>

Rollover Recommendations

SEC RIA Interpretation

The RIA Interpretation does not discuss the factors to be considered in making a rollover recommendation.

SEC Regulation Best Interest

In Reg BI, the SEC mentioned the following non-exclusive factors, in addition to the participant's existing account and investment profile:

- Fees and expenses;
- Level of service available;
- Available investment options;
- Ability to take penalty-free withdrawals;
- Application of required minimum distributions;
- Protection from creditors and legal judgments;
- Holdings of employer stock; and
- Any special features of the existing account.

Disclosure of Conflicts of Interest

SEC RIA Interpretation	SEC Regulation Best Interest
<p>An adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.</p> <p>While disclosure of conflicts of interest can prevent those conflicts from violating the adviser’s fiduciary duty, such disclosure and consent do not themselves satisfy the adviser’s duty to act in the client’s best interest.</p>	<p>Broker-dealers must, prior to or at the time of the recommendation, 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 material fees and costs that apply to the retail customer’s transactions, holdings, and accounts; and all material facts relating to conflicts of interest associated with the recommendation.</p> <p>The Care Obligation and the Disclosure Obligation must be separately satisfied.</p>

Disclosure of Conflicts of Interest

SEC RIA Interpretation	SEC Regulation Best Interest
<p>In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the conflict of interest and make an informed decision whether to provide consent.</p> <p>Disclosure that an adviser “may” have a particular conflict, without more, is not adequate when the conflict actually exists.</p>	<p>Disclosure regarding conflicts must reasonably inform investors so that the investor may use the information to evaluate the recommendation.</p> <p>Although disclosure of specific compensation amounts is not required, full and fair disclosure may require disclosure of the general magnitude of the compensation. For example, a statement that a charge may be “between 5 and 100 basis points” would not be accurate if the fee is in almost all instances between 85 and 100 basis points.</p>

Material Conflicts of Interest

SEC RIA Interpretation	SEC Regulation Best Interest
<p>The RIA Interpretation does not explicitly require “mitigation” of incentives for advisers. Instead, the disclosures are more demanding and the duty of care must be independently be satisfied.</p>	<p>Reg BI requires that broker-dealers mitigate any conflicts of interest for their representatives that create an incentive to place the interest of the broker-dealer or the representative ahead of the interest of the retail customer.</p> <p>Reg BI eliminates 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.</p>

Reg BI: Conflicts of Interest

The SEC described the “mitigation” requirement as: policies and procedures that are reasonably designed to reduce the potential effect financial incentive conflicts may have on a recommendation given to a retail customer.

Whether or not the policies and procedures are reasonably designed to mitigate such conflicts is based on whether they are reasonably designed to reduce the incentive for the representative to make a recommendation that places the representative’s or firm’s interests ahead of the retail customer’s interest.

Material Conflicts of Interest

SEC RIA Interpretation	SEC Regulation Best Interest
<p>Material conflicts of interest for investment advisers can include rollover recommendations, transfers of accounts from other firms, the receipt of payments from custodians, receipt of solicitor's fees, and receipt of 12b-1 fees (if dually registered).</p>	<p>Material facts regarding conflicts for broker-dealers and their representatives can include rollover recommendations, insurance commissions and trails, mutual fund loads and 12b-1 fees, revenue sharing, commissions on securities transactions, and other third party payments.</p>

Reg BI: Conflicts of Interest

Reg BI requires that broker-dealers have policies and procedures related to conflicts of interest and that reasonably designed policies and procedures to identify conflicts of interest generally should:

- (i) define such conflicts in a manner that is relevant to a broker-dealer's business, in a way that enables employees to understand and identify conflicts of interest;
- (ii) establish a structure for identifying the types of conflicts that the broker-dealer (and its representatives) may face;

continued . . .

Reg BI: Conflicts of Interest

(iii) establish a structure to identify conflicts in the broker-dealer's business as it evolves;

(iv) provide for an ongoing and regular, periodic (*e.g.*, annual) review for the identification of conflicts associated with the broker-dealer's business; and

(v) establish training procedures regarding the broker-dealer's and its representatives' conflicts of interest, and how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest.

Monitoring

SEC RIA Interpretation	SEC Regulation Best Interest
<p>An investment adviser’s fiduciary duty of care includes, among other things, the duty to provide advice and monitoring over the course of the relationship.</p> <p>An investment adviser’s duty of care encompasses the duty to provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship.</p> <p>The responsibility to monitor can be defined by contract.</p>	<p>While broker-dealers are not required to monitor accounts, a broker-dealer can agree to provide monitoring services, and such an agreement will result in buy, sell or hold recommendations subject to Reg BI, even when the recommendation to hold is implicit.</p>

Discretion over Accounts

SEC RIA Interpretation	SEC Regulation Best Interest
<p>A person that provides comprehensive, discretionary advice must register as an investment adviser. A broker-dealer registration is not adequate.</p>	<p>There are situations where a broker-dealer may exercise temporary or limited discretion in a way that is not indicative of a relationship that is primarily advisory in nature.</p> <p>These are situations where the discretion is limited in time, scope, or other manner and lacks the comprehensive and continuous character of investment discretion that would suggest that the relationship is primarily advisory.</p>

Monitoring of Accounts and Investments

SEC RIA Interpretation	SEC Regulation Best Interest
<p>An agreement to continuously monitor would generally require registration as an investment adviser.</p>	<p>A broker-dealer that agrees to monitor a retail customer's account on a periodic basis for purposes of providing buy, sell, or hold recommendations may still be considered to provide advice in connection with and reasonably related to effecting securities transactions.</p> <p>A voluntary review of the holdings in a retail customer's account for the purposes of determining whether to provide a recommendation is not "account monitoring."</p>

Questions?

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