

THE REVIEW OF
**SECURITIES & COMMODITIES
REGULATION**

AN ANALYSIS OF CURRENT LAWS AND REGULATIONS
AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 55 No. 13 July 20, 2022

BROKER-DEALER AND INVESTMENT ADVISER ACCOUNT RECOMMENDATIONS

The SEC Staff recently released a bulletin titled “Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors.” In this article, the authors discuss the Staff Bulletin in detail, including observations on the ways in which the Bulletin appears to deviate from the SEC’s guidance under Reg BI and the IA Interpretation. They conclude with factors a firm should consider before making recommendations.

By Brian J. Baltz and John V. Ayanian *

Nearly 18 months into his tenure, Securities and Exchange Commission Chair Gary Gensler’s agenda with respect to the standards of conduct for broker-dealers and investment advisers seems to be coming into focus. At the start of his tenure, there were questions about whether Chair Gensler would revisit Regulation Best Interest (“Reg BI”) under the Securities Exchange Act of 1934¹ and the SEC’s 2019 interpretation of an investment adviser’s fiduciary duty (“IA Interpretation”) under Section 206(1) and (2) of the Investment Advisers Act of 1940.² Rather than

revisiting them, Chair Gensler has asked the SEC’s Divisions of Investment Management, Trading and Markets, Examinations, and Enforcement to help ensure that investment professionals live up to their obligations under Reg BI and the Advisers Act fiduciary duty.³

Perhaps the most significant action by the SEC Staff in response to Chair Gensler’s request to date was a March 2022 Staff bulletin titled “Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors” (“Staff Bulletin”).⁴ The Staff Bulletin is a series of questions

¹ Exchange Act Rule 15l-1; Regulation Best Interest, Securities Exchange Act Release No. 86031 (June 5, 2019), 84 Fed. Reg. 33318 (July 12, 2019) [hereinafter Reg BI Adopting Release].

² Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019), 84 Fed. Reg. 33669 (July 12, 2019) [hereinafter IA Interpretation].

³ “Investor Protection in a Digital Age,” Remarks Before the 2022 NASAA Spring Meeting & Public Policy Symposium, Gary Gensler, Chair, Secs. & Exch. Comm’n (May 17, 2022).

⁴ SEC Staff Bulletin, Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (Mar. 30, 2022), *available at*

** BRIAN J. BALTZ and JOHN V. AYANIAN are partners at McGuireWoods LLP in the Washington, DC office. They write: Our knowledge and experience span the range of regulatory and compliance issues impacting broker-dealers and investment advisers. We have built our practice to service our clients’ varied businesses, whether they are dual registrants, standalone broker-dealers or investment advisers, or institutional shops. Their e-mail addresses are bbaltz@mcguirewoods.com and jayanian@mcguirewoods.com.*

and answers that, according to the Staff, purport to “reiterat[e] the standards of conduct for broker-dealers and investment advisers when they are making account recommendations to retail investors.”⁵ As discussed below, however, the Staff Bulletin goes beyond the SEC’s guidance in the Reg BI Adopting Release and the IA Interpretation. While firms might consider the Staff Bulletin as a frame of reference when considering their obligations in making account recommendations, as the Staff notes, the Staff Bulletin “represents the views of the staff”; “is not a rule, regulation, or statement of,” and has not been approved or disapproved by, the Commission; and “like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.”

This article first describes the SEC’s guidance under Reg BI and the IA Interpretation as they relate to account recommendations. It then discusses the Staff Bulletin and our observations, including the ways in which the Staff Bulletin deviates from the SEC’s guidance and considerations for firms when making account recommendations.

SEC GUIDANCE ON ACCOUNT RECOMMENDATIONS

The SEC has long been concerned about whether broker-dealers and investment advisers are recommending the appropriate account type for a retail investor, including brokerage, advisory, and retirement accounts. After the D.C. Circuit Court vacated Advisers

Act Rule 202(a)(11)-1,⁶ the SEC witnessed an increasing migration of brokerage assets to advisory relationships.⁷ The SEC’s adoption of Reg BI and issuance of the IA Interpretation were at least in part designed to address concerns about account recommendations. Below we discuss the SEC’s guidance on account recommendations under Reg BI and the IA Interpretation.

Account Recommendations Under Reg BI

Reg BI includes a “best interest” obligation for a broker-dealer and its associated persons that requires them, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, to act in the best interest of the retail customer at the time the recommendation is made, without placing the broker-dealer’s or associated person’s financial or

⁶ *Financial Planning Ass’n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

⁷ Mark Schoeff Jr., *SEC Eyes Movement of Funds Between Brokerage Advisory Accounts*, INVESTMENTNEWS (Feb. 26, 2014), available at <https://www.investmentnews.com/sec-eyes-movement-of-funds-between-brokerage-advisory-accounts-56182> (“The Securities and Exchange Commission has noticed a lot of client movement from brokerage accounts to advisory accounts in the investment advice business and is keeping its eye on whether the transition is good for clients, an SEC official said on Thursday.”). In response to concerns about firms’ recommendations of rollovers from employer retirement plans to individual retirement accounts, the SEC launched a multi-year Retirement-Targeted Industry Reviews and Examinations (ReTIRE) Initiative in 2015. National Exam Program Risk Alert, Retirement-Targeted Industry Reviews and Examinations Initiative (June 22, 2015), available at <https://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf>. The Financial Industry Regulatory Authority (“FINRA”), the self-regulatory organization for broker-dealers dealing with the public, also issued guidance on the obligations of broker-dealers in recommending IRA rollovers. FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers, FINRA Regulatory Notice 13-45 (Dec. 2013), available at <https://www.finra.org/rules-guidance/notices/13-45>.

footnote continued from previous page...

<https://www.sec.gov/tm/iabd-staff-bulletin>. The Staff previously issued a statement regarding Form CRS disclosures. Standards of Conduct Implementation Committee, Staff Statement Regarding Form CRS Disclosures (Dec. 17, 2021), available at <https://www.sec.gov/news/statement/staff-statement-form-crs-disclosures-121721>.

⁵ The Staff refers to “retail investors” as inclusive of a retail customer under Reg BI and a natural person client of an investment adviser.

other interest ahead of the retail customer's interest.⁸ A broker-dealer satisfies the best interest obligation by meeting four component obligations: (1) disclosure obligation; (2) care obligation; (3) conflict-of-interest obligation; and (4) compliance obligation.

Disclosure Obligation. The disclosure obligation requires a broker-dealer, prior to or at the time of making a recommendation, to provide the retail customer, in writing, full and fair disclosure of all material facts relating to:

1. The scope and terms of the relationship with the retail customer, including
 - a) That the broker-dealer is acting in its capacity of a broker-dealer with respect to the recommendation;
 - b) The material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and
 - c) The type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies that may be recommended to the retail customer; and
2. Conflicts of interest that are associated with the recommendation.⁹

In adopting Reg BI, the SEC stated that a standalone broker-dealer (i.e., a broker-dealer that is not also registered as an investment adviser) would generally be able to satisfy the capacity disclosure requirement by delivering Form CRS to the retail customer.¹⁰ For a dual

⁸ Exchange Act Rule 15l-1(a)(1). Reg BI applies not just to a broker-dealer, but also to its associated persons. For ease of reading, we refer only to broker-dealers and not associated persons (i.e., financial professionals).

⁹ Exchange Act Rule 15l-1(a)(2)(i). "[T]he standard for materiality for purposes of the Disclosure Obligation is consistent with the one the Supreme Court articulated in *Basic v. Levinson*. Specifically, a fact is material if there is 'a substantial likelihood that a reasonable shareholder would consider it important.' In the context of Regulation Best Interest, the standard is the retail customer, as defined in the rule." Reg BI Adopting Release, 84 Fed. Reg. at 33347.

¹⁰ Reg BI Adopting Release, 84 Fed. Reg. at 33350. Form CRS is a disclosure document that broker-dealers and investment advisers are required to deliver to retail investors that describes their services, fees, costs, conflicts of interest, standard of

registrant, the disclosure obligation was intended to "provide clarifying detail on capacity to supplement the information contained in" Form CRS.¹¹

Care Obligation. The care obligation requires a broker-dealer, in making a recommendation, to exercise reasonable diligence, care, and skill in satisfying the reasonable-basis, customer-specific, and quantitative components.

- *Reasonable-basis component:* requires a broker-dealer to understand the potential risks, rewards, and costs associated with a recommendation, and have a reasonable basis to believe the recommendation could be in the best interest of at least some retail customers.
- *Customer-specific component:* requires a broker-dealer to 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 profile¹² and the potential risks, rewards, and costs associated with the recommendation, and does not place the broker-dealer's or associated person's financial or other interest ahead of the retail customer's interest.
- *Quantitative component:* requires a broker-dealer to have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile, and does not place the broker-dealer's or associated person's financial or other interest ahead of the retail customer's interest.¹³

footnote continued from previous column...

conduct, disciplinary information, and how to obtain additional information.

¹¹ *Id.*

¹² Reg BI defines retail customer investment profile to include, but not be limited to, the retail 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 retail customer may disclose to the broker-dealer in connection with a recommendation. Exchange Act Rule 15l-1(b)(2).

¹³ Exchange Act Rule 15l-1(a)(2)(ii).

In adopting Reg BI, the SEC stated its view that a broker-dealer generally should consider reasonably available alternatives offered by the broker-dealer in determining whether it has a reasonable basis to believe that a recommendation is in the best interest of the retail customer.¹⁴ The SEC clarified that a broker-dealer does not have to conduct an evaluation of every possible alternative, or “recommend the single ‘best’ of all possible alternatives that might exist.”¹⁵

In addition to reasonably available alternatives, a broker-dealer is required to consider the costs of the recommended security or investment strategy involving securities. Cost, however, “is not a dispositive factor” or the only factor that must be considered.¹⁶ In addition, the SEC stated that a broker-dealer “could recommend a more expensive security or investment strategy if there are other factors . . . that reasonably allow the broker-dealer to believe it is in the best interest of the retail customer.”¹⁷

As noted above, Reg BI was at least in part designed to address concerns about account recommendations. This includes recommendations to open a particular securities account; to roll over or transfer assets in a workplace retirement plan account to an IRA; and to take a plan distribution for the purpose of opening a securities account.¹⁸ The SEC described the types of accounts broadly to include not just brokerage versus investment advisory accounts, but also specialty accounts (e.g., cash or margin accounts, and accounts with access to Forex or options trading), accounts with different levels of services or products, education accounts (e.g., 529 Plans and tax-free Coverdell accounts), and other tax-favored savings arrangements (e.g., Archer Medical Savings Accounts and Health Savings Accounts).¹⁹

The SEC provided guidance as to the factors that generally should be considered in recommending an account type:

- *Recommending an account type:* The SEC stated that a broker-dealer generally should consider “(1) the services and products provided in the

account (ancillary services provided in conjunction with an account type, account monitoring services, etc.); (2) the projected cost to the retail customer of the account; (3) alternative account types available; (4) the services requested by the retail customer; and (5) the retail customer’s investment profile.”²⁰

- *Recommending a retirement account:* The SEC stated that a broker-dealer generally should consider “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.”²¹

The SEC acknowledged that retail customer-specific factors might not be applicable or available in every context; might have more or less relevance; and might not be obtained or analyzed at all where the broker-dealer has a reasonable basis for believing that a particular factor is or is not relevant.²²

Conflict-of-Interest Obligation. The conflict-of-interest obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to:

1. identify, and at a minimum disclose or eliminate, all conflicts of interest associated with recommendations;
2. identify and mitigate any conflicts of interest associated with recommendations that create an incentive for an associated person to place the broker-dealer’s or associated person’s interest ahead of the retail customer’s interest;
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 associated person to make recommendations that place the broker-dealer’s or associated person’s interest ahead of the retail customer’s interest; and

¹⁴ Reg BI Adopting Release, 84 Fed. Reg. at 33381.

¹⁵ *Id.*

¹⁶ *Id.* at 33373.

¹⁷ *Id.* at 33381.

¹⁸ *Id.* at 33325.

¹⁹ *Id.* at 33337 n.174 and 33343 n.250.

²⁰ *Id.* at 33382-83.

²¹ *Id.* at 33383.

²² *Id.*

-
4. identify 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 (referred to herein as “sales contests”).²³

In adopting Reg BI, the SEC acknowledged that requiring mitigation of firm-level financial incentives, “which is not required by an investment adviser’s fiduciary duty,” could raise competitive issues and “further encourage migration from the broker-dealer to investment adviser model and result in a loss of choice for retail customers.”²⁴ “Accordingly, rather than requiring mitigation of all firm-level financial incentives, we have determined to refine our approach by generally allowing firm-level conflicts to be generally addressed through disclosure.”²⁵ The conflicts that require mitigation or elimination are identified in Reg BI: namely, those in (2) through (4) above.

With respect to mitigation of certain incentives to a financial professional, the SEC did not prescribe a one-size-fits-all approach or mandate any particular mitigation measures. Rather, the SEC stated that “whether or not a broker-dealer’s policies and procedures are reasonably designed to mitigate conflicts will be based on whether they are reasonably designed to *reduce* the incentive” for the financial professional to place the broker-dealer’s or the financial professional’s interests ahead of the retail customer’s interests.²⁶ The SEC provided some examples of potential mitigation methods, including:

- avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- minimizing compensation incentives for financial professionals to favor one type of account over another; and
- implementing supervisory procedures to monitor recommendations that are near thresholds for compensation or firm recognition or involve the roll over or transfer of assets from one type of account to another.

Compliance Obligation. The compliance obligation requires a broker-dealer, in addition to the policies and

procedures required under the conflict-of-interest obligation, to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI.²⁷

Account Recommendations Under the IA Interpretation

An investment adviser owes a federal fiduciary duty to its clients under Section 206(1) and (2) of the Advisers Act.²⁸ The SEC has described an adviser’s fiduciary duty as broad and applying to the entire adviser-client relationship.²⁹ “The fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent.”³⁰ In this regard, the SEC has stated that “the specific obligations that flow from the adviser’s fiduciary duty depend upon what functions the adviser, as agent, has agreed to assume for the client, its principal.”³¹

The fiduciary duty includes both a duty of loyalty and a duty of care. The SEC has stated that the “duty of loyalty requires that an adviser not subordinate its clients’ interests to its own.”³² An investment adviser should make full and fair disclosure to its clients of all material facts relating to the advisory relationship.³³ According to the SEC, an investment adviser’s duty of loyalty includes an obligation to disclose when a dual registrant intends to act as an investment adviser or broker-dealer, which “may be accomplished through a variety of means, including, among others, written disclosure at the beginning of a relationship that clearly sets forth when the dual registrant would act in an advisory capacity and how it would provide notification of any changes in capacity.”³⁴

The SEC has stated that the “duty of care includes a duty to provide investment advice that is in the best interest of the client, including a duty to provide advice

²³ Exchange Act Rule 15l-1(a)(2)(iii).

²⁴ Reg BI Adopting Release, 84 Fed. Reg. at 33390 n.739.

²⁵ *Id.* at 33390.

²⁶ *Id.* at 33391 (emphasis added).

²⁷ Exchange Act Rule 15l-1(a)(2)(iv).

²⁸ *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 194 (1963).

²⁹ IA Interpretation, 84 Fed. Reg. at 33670.

³⁰ *Id.* at 33671.

³¹ *Id.*

³² *Id.* at 33675.

³³ *Id.*

³⁴ *Id.* at 33675-76.

that is suitable for the client.”³⁵ According to the SEC, this requires the adviser to have a reasonable understanding of the client’s objectives, which will vary based on the specific facts and circumstances, including the nature of the client, the scope of the adviser-client relationship, and the nature and complexity of the anticipated investment advice.”³⁶ With respect to retail investors, the SEC has stated this means “an adviser should, at a minimum, make a reasonable inquiry into the client’s financial situation, level of financial sophistication, investment experience, and financial goals.”³⁷ The duty of care also requires (similar to the reasonable-basis component of Reg BI’s care obligation) “that an adviser conduct a reasonable investigation into the investment sufficient not to base its advice on materially inaccurate or incomplete information.”³⁸ Also similar to Reg BI, an investment adviser is expected to consider the cost of an investment product or strategy, but is not necessarily required to recommend the one with the lowest cost.³⁹ The SEC recognized that an “adviser could recommend a higher-cost investment or strategy if the adviser reasonably concludes that there are other factors about the investment or strategy that outweigh cost and make the investment or strategy in the best interest of the client, in light of that client’s objectives.”⁴⁰

The SEC also stated that an adviser’s fiduciary duty applies to all investment advice provided to clients (not prospective clients), including advice about account type (e.g., whether to open or invest through a certain type of account and roll over assets from one account into a new or existing account that the adviser manages).⁴¹ “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.”⁴² While an investment adviser’s fiduciary duty only applies to dealings with clients, the SEC sought to shoehorn advice provided prior to the establishment of an adviser-client relationship into an adviser’s fiduciary duty. Specifically, the SEC stated that an “adviser must also satisfy its fiduciary duty with respect to . . . advice [to prospective clients] (e.g., regarding account type) when a prospective client becomes a client.”⁴³

STAFF BULLETIN ON ACCOUNT RECOMMENDATIONS

The Staff Bulletin provides the Staff’s views on how broker-dealers and investment advisers can satisfy their obligations under Reg BI and an investment adviser’s fiduciary duty in making account recommendations. It covers a range of topics, including obligations of dual registrants, factors to consider before making an account recommendation, documenting the basis for a recommendation, and mitigating conflicts of interest. In certain ways, the Staff Bulletin appears to be the Staff’s attempt to fill perceived gaps in the standards of conduct for broker-dealers and investment advisers that were not addressed by the Commission in the Reg BI Adopting Release or IA Interpretation.

Obligations of Dual Registrants

The Staff stated that the standard of conduct a dual registrant must follow in making an account recommendation depends on the capacity in which it is acting. According to the Staff, “in many cases, both Reg BI and the Advisers Act apply as you assess an account type recommendation for current and prospective retail investors.”⁴⁴ “Where you have not yet *established* the capacity in which you will be acting, you should assume that both standards apply and disclose to the investor, prior to or at the time of the recommendation, that you are acting in both capacities.”⁴⁵

Observations. The Staff’s view that both Reg BI and the Advisers Act apply when a dual registrant makes an account recommendation seems to depart from the Commission’s guidance. In both the Reg BI Adopting Release and IA Interpretation, the Commission indicated

³⁵ *Id.* at 33672.

³⁶ *Id.* at 33673.

³⁷ *Id.*

³⁸ *Id.* at 33674.

³⁹ *Id.* (“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 (including any special or unusual features), 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 involving a security or securities is in the best interest of the client.”).

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.* at 33674 n.42.

⁴⁴ Staff Bulletin at 1.a.

⁴⁵ *Id.* at 1.b (emphasis added).

that the obligations a dual registrant owes to a retail investor depend on the capacity in which the dual registrant is acting.⁴⁶ For example, the Commission was clear that Reg BI would not apply to investment advice provided in an investment advisory capacity even if the retail investor has a brokerage relationship with the dual registrant.⁴⁷ One of the factors the Commission would consider in determining capacity includes “the extent to which the dual-registrant made clear to the customer or client the capacity in which it was acting.”⁴⁸ The SEC did not suggest in either the Reg BI Adopting Release or the IA Interpretation any circumstance in which both standards of conduct would apply to a dual registrant, including when the dual registrant made clear the capacity in which it (or its financial professional) was acting.

Moreover, the Staff’s focus on whether a dual registrant has “established” the capacity in which it will be acting is especially peculiar. If the Staff is suggesting that capacity is determined when a retail investor has established a brokerage or investment advisory relationship with a dual registrant, that would depart from the Commission’s focus on disclosure of capacity before or at the time of a recommendation. For example, the SEC stated in the IA Interpretation that dual registrants “should provide full and fair disclosure about the circumstances in which they intend to act in their brokerage capacity and the circumstances in which they intend to act in their advisory capacity,” and noted that the disclosure may be accomplished through a variety of means without specifying any particular method.⁴⁹ Nowhere in the Reg BI Adopting Release or the IA Interpretation did the Commission discuss establishing a capacity (other than through disclosure). Moreover, the Staff’s focus on establishing a capacity appears to be inconsistent with the Staff’s August 2020 response to a frequently asked question about Reg BI, which stated that an account recommendation generally should be

evaluated under both Reg BI and the Advisers Act where a dually registered financial professional “has not clearly disclosed the capacity in which he or she is acting.”⁵⁰

Factors to Consider Before Making an Account Recommendation

The Staff believes that a firm, when recommending an account type, should consider the retail investor’s investment profile;⁵¹ anticipated investment strategy; level of financial sophistication; preference for making her own investment decisions or relying on advice from a financial professional; and need or desire for account monitoring or ongoing account management.⁵² In addition, a firm should have a reasonable understanding of the characteristics of a particular type of account, including services and products provided in the account, the projected costs to the retail investor, alternative account types available, and whether the account offers the services requested by the retail investor.⁵³ The Staff stated that a firm must have a reasonable basis to believe that an account recommendation is not based on materially inaccurate or outdated information,⁵⁴ and that a firm “will not be able to have a reasonable belief that an account recommendation is in an investor’s best interest under Reg BI or the IA fiduciary standard without sufficient information about the retail investor, and therefore should generally decline such account recommendations until [the firm] obtain[s] the necessary investor information.”⁵⁵

Observations. The Staff’s description of a retail investor’s investment profile is broader than the retail customer investment profile under Reg BI and would require a broker-dealer to also consider the retail investor’s marital status, assets, and debts. These factors

⁴⁶ Reg BI Adopting Release, 84 Fed. Reg. at 33383 (“Where a financial professional who is dually registered (i.e., an associated person of a broker-dealer and a supervised person of an investment adviser (regardless of whether the professional works for a dual-registrant, affiliated firm, or unaffiliated firm)) is making an account recommendation to a retail customer, whether Regulation Best Interest or the Advisers Act will apply will depend on the capacity in which the financial professional making the recommendation is acting.”).

⁴⁷ *Id.* at 33345.

⁴⁸ *Id.* at 33346. Others include the type of account, how the account is described, and the type of compensation.

⁴⁹ *Id.* at 33675–76.

⁵⁰ Frequently Asked Questions on Regulation Best Interest, available at <https://www.sec.gov/tm/faq-regulation-best-interest>.

⁵¹ The Staff describes the retail investor investment profile as including financial situation (including current income) and needs; investments; assets and debts; marital status; tax status; age; investment time horizon; liquidity needs; risk tolerance; investment experience; investment objectives and financial goals; and any other information the retail investor may disclose in connection with an account recommendation. Staff Bulletin at 2.a.

⁵² *Id.*

⁵³ *Id.* at 2.c.

⁵⁴ *Id.* at 2.a.

⁵⁵ *Id.* at 2.b.

appear to be drawn from the Commission’s description of the personal and financial information an investment adviser should consider in undertaking to formulate a comprehensive financial plan.⁵⁶ It is not apparent how those factors are relevant to an account recommendation and the Staff did not provide any further explanation.

In addition, the Staff’s statement that a firm must have a reasonable basis to believe that an account recommendation is not based on materially inaccurate or outdated information appears overbroad. For example, in adopting Reg BI, the SEC stated that “broker-dealers may generally rely on a retail customer’s responses absent ‘red flags’ indicating that the information is inaccurate,” and that a broker-dealer “generally should make a reasonable effort to ascertain information regarding an existing customer’s investment profile prior to the making of a recommendation on an ‘as needed’ basis — that is, where a broker-dealer knows or has reason to believe that the customer’s investment profile has changed.”⁵⁷ Similarly, the SEC stated that the frequency with which an investment adviser must update a retail investor’s investment profile would “turn on the facts and circumstances, including whether the adviser is aware of events that have occurred that could render inaccurate or incomplete the investment profile on which the adviser currently bases its advice.”⁵⁸

Cost. The Staff noted that cost must always be considered in making an account recommendation.⁵⁹ According to the Staff, while Reg BI and an investment adviser’s fiduciary duty do not always obligate a firm to recommend the least expensive type of account, a firm that recommends a higher cost account must have a reasonable basis to believe the account is nonetheless in the retail investor’s best interest based on other factors and the situation and needs of the retail investor.⁶⁰ The Staff stated that a firm should consider the total potential costs in evaluating an account recommendation, including account fees, commissions and other transaction costs, tax considerations, other indirect costs (e.g., payment for order flow, cash sweep programs) and, where applicable, fees associated with investment products available in the account.⁶¹ In addition, where the impact of costs depends on the retail investor’s

anticipated investment horizon, the Staff believes the firm should consider the potential impact of those costs based on the investment horizon.⁶²

Observations. In adopting Reg BI and the IA Interpretation, the SEC recognized that factors other than cost may be considered when determining whether an account type is in a retail customer’s best interest.⁶³ The Staff’s focus on payment for order flow and cash sweep programs appears to be misplaced. The SEC did not mention or discuss payment for order flow or cash sweep in the Reg BI Adopting Release or the IA Interpretation. In addition, it is not clear how the Staff came to classify payment for order flow or cash sweep programs as “costs” to a retail investor — since they are not directly or indirectly paid by the retail investor — or how the Staff would envision a firm should analyze the receipt of payment for order flow or the availability of a cash sweep program in making an account recommendation among other factors.

Reasonably Available Alternatives. The Staff stated that a firm needs to consider reasonably available alternatives when making account recommendations and can recommend an account only if the firm has a reasonable basis to believe that the account is in the retail investor’s best interest. In addition, the Staff believes firms should consider the spectrum of accounts offered; cannot recommend an account that is not in a retail investor’s best interest solely based on a limited product menu or financial professional’s limited licensing; and should disclose any limitations on account types offered.⁶⁴

Observations. As noted above, in adopting Reg BI, the SEC clarified that a broker-dealer does not have to “recommend the single ‘best’ of all possible alternatives that might exist.”⁶⁵ Consistent with this, a firm should not be required to recommend the single best account among the available account types where the recommended account is otherwise in the retail investor’s best interest.

Retirement Account Rollover Recommendations. According to the Staff, a firm making a rollover recommendation must have a reasonable basis to believe both that the rollover itself and that the account being

⁵⁶ IA Interpretation, 84 Fed. Reg. at 33673.

⁵⁷ Reg BI Adopting Release, 84 Fed. Reg. at 33379.

⁵⁸ IA Interpretation, 84 Fed. Reg. at 33673.

⁵⁹ Staff Bulletin at 3.a.

⁶⁰ *Id.* at 3.a.

⁶¹ *Id.* at 3.b.

⁶² *Id.*

⁶³ Reg BI Adopting Release, 84 Fed. Reg. at 33383; IA Interpretation, 84 Fed. Reg. at 33674.

⁶⁴ Staff Bulletin at 1.c.

⁶⁵ Reg BI Adopting Release, 84 Fed. Reg. at 33383.

recommended are in the retail investor's best interest. Factors a firm should generally consider include costs; level of services available; features of the existing account, including costs; available investment options; ability to take penalty-free withdrawals; application of required minimum stock distributions; protection from creditors and legal judgments; and holdings of employer stock.⁶⁶ The Staff stated its view that it would be difficult to satisfy a firm's obligations without considering the alternative of leaving the retail investor's investments in the employer's plan, where that is an option.⁶⁷ "To evaluate any recommendation to transfer assets out of an employer's plan, or between individual retirement accounts, [a firm] would need to obtain information about the existing plan, including the costs associated with the options available in the investor's current plan."

Observations. The Staff's statement that a firm must obtain information about the retail investor's existing plan or IRA seems impractical as there is no single, publicly available source containing the information. While a firm might seek to obtain information about a retail investor's plan or IRA from the retail investor (e.g., by asking if the retail investor can provide the plan's annual fee disclosures), the retail investor might not have those disclosures available or have difficulty finding them.⁶⁸ In the absence of this information, a firm might consider other approaches, such as disclosure that the firm does not have the information to consider in making a recommendation or that the firm will assume an IRA is more expensive, and an associated acknowledgment from the retail investor.⁶⁹

⁶⁶ Staff Bulletin at 4.a.

⁶⁷ *Id.* at 4.b.

⁶⁸ Many firms found this challenging in the context of since-vacated Best Interest Contract Exemption from the Department of Labor ("DOL").

⁶⁹ Reg BI Adopting Release, 84 Fed. Reg. at 33379 ("Moreover, as noted in the Proposing Release, one or more factors may have more or less relevance, or may not be obtained or analyzed at all if the broker-dealer has a reasonable basis for determining that the factor is irrelevant to that particular best interest determination. However, consistent with existing obligations, where a broker-dealer determines not to obtain or analyze one or more of the factors specifically identified in the definition of 'Retail Customer Investment Profile,' the broker-dealer should document its determination that the factor(s) are not relevant components of a retail customer's investment profile in light of the facts and circumstances of the particular recommendation."). Regardless of the approach taken under

Role of Retail Investor Preferences. The Staff appears to suggest that retail investor preference can play a role in making an account recommendation.⁷⁰ The Staff does not believe that making an account recommendation solely on the basis of a retail investor's preference would satisfy the standards.⁷¹ However, if a retail investor ultimately directs a firm to open an account that is contrary to the recommendation, the firm would not be required to refuse to accept the retail investor's direction.

Observations. It was nice to see the Staff acknowledge that retail investor preferences can be an important factor in making an account recommendation. Ultimately, retail investor preferences about the types of services (e.g., one-time, periodic, or ongoing advice and monitoring, access to securities and investment strategies) and fee arrangements (e.g., transaction charges, annual fees) that a retail investor is seeking can be important factors in recommending an account type.

Documenting the Basis for a Recommendation

The Staff appears to be suggesting that firms must document the basis for a recommendation. The Staff repeatedly stated that it "may be difficult for a firm to assess periodically the adequacy and effectiveness of its policies and procedures, or to demonstrate compliance with its obligations to retail investors without documenting the basis for the recommendation."⁷² The Staff notes, however, the Commission has not specifically addressed such documentation for investment advisers and did not require broker-dealers to document the basis for any recommendations in the Reg BI Adopting Release, and instead encouraged broker-dealers to take a risk-based approach when deciding whether to document certain recommendations.⁷³

Observations. The Staff's suggestion that firms must document the basis for a recommendation might potentially become an item that is raised during examinations. As the Staff notes, the SEC did not

footnote continued from previous column...

Reg BI and the IA Interpretation, firms also need to consider obligations under DOL Prohibited Transaction Exemption 2020-02. *See also* FINRA Regulatory Notice 13-45, *supra* note 7.

⁷⁰ Staff Bulletin at 2.a.

⁷¹ *Id.* at 5.

⁷² *Id.* at 6.

⁷³ *Id.* at n.26.

require that broker-dealers document the basis for any particular type of recommendation, and instead allowed broker-dealers to take a risk-based approach in deciding whether to document certain recommendations.

While the SEC described recording the basis for recommendations of rollovers and choice of accounts as a potential way to demonstrate compliance with Reg BI's care obligation, the SEC did not require broker-dealers to create and maintain records to evidence best interest determinations on a recommendation-by-recommendation basis or provide information to retail customers relating to the basis for each particular recommendation. "Instead, broker-dealers should be able to explain in broad terms the process by which the firm determines what recommendations are in its customers' best interests, and similarly to explain how that process was applied to any particular recommendation to a retail customer."⁷⁴ Moreover, "broker-dealers are not expected to maintain records comparing potential investments to one another so long as they are able to demonstrate that each individual recommendation actually made to a customer meets the requirements of Regulation Best Interest on its own."⁷⁵ This latter point might be especially pertinent with respect to rollover recommendations where a firm does not have access to information about a retail investor's current plan or IRA.

Mitigating Conflicts of Interest

The Staff provided some examples of practices that it believes can assist firms in meeting their obligations with respect to conflicts of interest associated with account recommendations.⁷⁶ Those included:

- avoiding compensation thresholds that disproportionately increase compensation through openings of certain account types;
- adopting and implementing policies and procedures reasonably designed to minimize or eliminate incentives, including both compensation and non-compensation incentives, for employees to favor one type of account over another;
- implementing supervisory procedures to monitor recommendations that involve the roll over or

transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA); and

- adjusting compensation for financial professionals who fail to adequately manage conflicts of interest associated with account recommendations.

Further, the Staff "strongly encourages firms to eliminate or mitigate any incentive that poses a risk of causing the firm or its financial professionals to place their interests ahead of the retail investor's interest."

Observations. The Staff's suggestion that a firm might be required to eliminate or mitigate any incentive (i.e., at either the firm or financial professional level) that poses a risk of causing the firm or its financial professionals to place their interests ahead of a retail investor's interest appears to depart from the SEC's guidance in adopting Reg BI and an investment adviser's fiduciary duty. Under Reg BI, only sales contests are required to be eliminated, and "most firm-level conflicts of interest can be addressed through appropriate disclosure."⁷⁷ While Reg BI requires mitigation of incentives at the financial professional level, the SEC interpreted that requirement as applying only to incentives "provided to" the financial professional, and not incentives provided to the broker-dealer.⁷⁸

Similarly, an investment adviser's fiduciary duty does not require the elimination of conflicts of interest. The Supreme Court has noted that the Advisers Act reflects "a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an adviser — consciously or unconsciously — to render advice which was not disinterested."⁷⁹ In the IA Interpretation, the SEC stated that full and fair disclosure of conflicts such that a client can provide informed consent is sufficient to satisfy the duty of loyalty, and an adviser should either eliminate or mitigate a conflict where it cannot provide full and fair disclosure such that the client can provide informed consent.

⁷⁴ Reg BI Adopting Release, 84 Fed. Reg. at 33399.

⁷⁵ *Id.*

⁷⁶ Staff Bulletin at 7.

⁷⁷ Reg BI Adopting Release, 84 Fed. Reg. at 33393. The SEC suggested that there might be circumstances where mitigation of a conflict is needed to provide full and fair disclosure of a conflict. *Id.* at 33388.

⁷⁸ *Id.* at 33391.

⁷⁹ *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 191-92 (1963).

CONCLUSION

It will be interesting to watch the direction of the next round of Reg BI and investment adviser fiduciary duty examinations take shape. One might expect that the EXAMS Staff will seek to pursue the expanded concepts laid out in the Staff Bulletin in examination requests and interviews. As firms interact with the Staff in the course of examinations, they should be mindful of the expansive approach the Staff is taking with respect to

account recommendations, including how that approach deviates from the SEC's guidance, and also note the Staff's pronouncement that the Staff Bulletin "has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person." Time will tell whether EXAMS or the Division of Enforcement will attempt to bake these expanded concepts into the requirements underpinning both regulatory regimes through examinations and enforcement actions. ■

The Review of Securities & Commodities Regulation

General Editor

Michael O. Finkelstein

Associate Editor

Sarah Strauss Himmelfarb

Board Members

Jay Baris

Sidley Austin LLP
New York, NY

Rita M. Molesworth

Willkie Farr & Gallagher LLP
New York, NY

John C. Coffee, Jr.

Columbia Law School
New York, NY

Anna T. Pinedo

Mayer Brown
New York, NY

Ralph C. Ferrara

Proskauer Rose LLP
Washington, DC

Norman S. Poser

Brooklyn Law School
Brooklyn, NY

Roberta S. Karmel

Brooklyn Law School
Brooklyn, NY

Benjamin P. Saul

GreenbergTraurig, LLP
Washington, DC