

Fiduciary Commentary: SEC Adopts Best Interest Regulations

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SEC Adopts Best Interest Regulations

On June 5, 2019, the Securities and Exchange Commission voted to adopt Regulation Best Interest (Regulation BI). The SEC's action, supported by the broker-dealer industry, comes a year after regulators first proposed the package of initiatives. The Regulation is designed to raise the advice standard for broker-dealers when making investor recommendations above the current suitability rule. In a 3-to-1 vote, the commissioners approved the Regulation Best Interest and other initiatives to enhance disclosures and to provide greater transparency to investors with their relationships with broker-dealers.

Many investors believe that the advice they receive from financial professionals is objective when it is often biased in favor of investments that produce the greatest revenue or a tangential benefit for the advisor or firm. While the Best Interest Regulation would represent an improvement over the low-threshold suitability standard, many industry participants and investor advocates opposed the regulations on the grounds that it did not go far enough to protect investors' interests.

Background

Currently, the laws governing the standards of conduct for providing advisory services is nothing short of chaotic. Opposing rules apply different legal frameworks depending on the structure of the organization providing the services. As a result, some investors receive substantially different standards of advice depending on the type of organization they have engaged.

A fiduciary relationship is viewed as the highest standard of advice available under the law and requires the fiduciary to put the clients' interests first when making investment recommendations. Currently, a non-fiduciary stance subjects investors to a different, less demanding, "suitability standard" where their investment recommendations must simply be "suitable" for the client at the time the investment is made. This standard does not legally obligate a broker or firm to put the interests of their clients ahead of their own. In fact, it permits them to do the opposite.



Regulation BI attempts to substantially enhance the broker-dealer standard of conduct to serve retail investors better. Supporters say that this represents an improvement over the current "suitability" standard that brokers are held to today.

Timeline

The Regulation BI and related requirements become effective 60 days after publication in the Federal Register. At present, by June 30, 2020, registered broker-dealers must comply with the new regulations.

Regulation Summary

Regulation BI has a "general obligation," which requires that a broker or broker-dealer comply with four-component obligations when making a recommendation to a retail customer. The general obligation requires broker-dealers and their brokers to act in their clients' best interest when providing investment recommendations without placing their financial or other interests ahead of the investor's interests.

Further, the rule extends to all account types, including individual retirement accounts and recommendations to roll over or transfer assets in a workplace retirement plan account.

The regulation provides that there is a “general obligation” to act in the customer’s best interest and is satisfied by complying with the following specific obligations:

- ⊗ **Disclosure Obligation:** Broker-dealers or associated person must disclose material facts about the relationship and the investment recommendation. These disclosures include the capacity the broker is acting, fees, type, and scope of services provided, any limitations, and if the broker-dealer provides investment monitoring services.
- ⊗ **Care Obligation:** Broker-dealers or associated person must exercise reasonable diligence, care, and skill when making an investment recommendation. The potential risks, rewards, and costs with the investment recommendation must be understood. These factors must be considered in light of the customer’s investment profile to ensure there is a reasonable basis to believe the recommendation is in the client’s best interest. The final regulation explicitly requires the broker-dealer to consider the costs of the investments before making a recommendation.
- ⊗ **Conflict Obligation:** The broker-dealer must establish, maintain, and enforce policies and procedures intended to identify and disclose conflicts of interest. Specifically, policies and procedures must be maintained to:
 - Mitigate conflicts that create an incentive for the associated persons to place their interests ahead of customers.
 - Prevent material limitations on investment offerings (such as proprietary only investment menus) from causing the firm or associated persons to place their interests ahead of their customers.
 - Eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are related to the sale of specific securities.
- ⊗ **Compliance Obligation:** Broker-dealers must establish, maintain, and enforce policies that are designed to ensure compliance with the regulation.

The proposal includes a list of activities that fall outside the scope of a recommendation, including:

- ⊗ General financial and investment information
- ⊗ Descriptive information about an employer-sponsored retirement plan
- ⊗ Certain asset allocation models
- ⊗ Interactive investment materials that incorporate the exclusions

Furthermore, the SEC also adopted new rules that require both broker-dealers and RIAs to provide investors with a “customer relationship summary” (Form CRS) that summarizes the investment relationship. Firms will summarize information about the investments, services, fees, conflict of interests, standards of conduct, and the disciplinary history of the firm and its representatives.

The regulation does not apply the existing RIA fiduciary standard to broker-dealers and is not a fiduciary standard. The general obligation does not propose to require broker-dealers to make conflict-free recommendations. It does, however, require broker-dealers to take steps to reduce conflicts of interest that might encourage a conflicted recommendation. Products that have higher costs, risks, or produce higher fees to the broker-dealer may be offered if each of the four components is satisfied.

Conclusion

Many practitioners believe that all investment and financial advice should be held to a fiduciary standard, because the cost to those receiving conflicted investment advice is too high to ignore*. Wall Street has a strong financial incentive to maintain the status quo, and critics believe there is too much money being made to effect real change - and again investors’ interest will be subordinated to the interests of Wall Street.

* According to the White House’s Council of Economic Advisors, the cost of tainted investment advice is approximately \$17 billion annually.