Perspective

2018 SEC best interest proposals

What do they mean for investment advisors?

By Fred Reish, Drinker Biddle & Reath LLP

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TD Ameritrade Institutional

Dear valued Advisor,

Hard to believe, but it's been more than 13 years since TD Waterhouse submitted a formal comment letter to the Securities and Exchange Commission outlining our concerns about the "Merrill Lynch Rule"—which would have let brokers charge fees for brokerage accounts, yet not answer to the '40 Act.

When the Merrill Lynch Rule was overturned by the courts in 2007, an important competitive advantage was preserved for registered investment advisors. We've been fighting alongside RIAs ever since.

Part of our commitment to RIA advocacy is keeping clients like you informed of key policy developments that can impact your business. And, the SEC recently proposed a landmark series of rules that will redefine the landscape for years to come.

Announced April 18, the three-part package includes proposals to:

1. Raise the standard of care among broker-dealers, known as Regulation Best Interest
2. Enhance disclosures through a standardized client relationship summary, Regulation CRS
3. Clarify and revise the regulations applicable to RIAs, titled "Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisors"

The SEC has invited public comment, but we doubt most advisors have the time to consume and digest proposals that stack up to nearly 1,000 pages. So, we asked a leading authority on advisor regulation, Fred Reish of Drinker Biddle & Reath LLP, to boil down some of the more important aspects to just 10 pages—a 99% reduction!

We encourage you to read this summary so that you may have a better understanding of what's being proposed, how it may affect your firm, and how to submit feedback to the SEC should you want (and we hope you do). Also, we would love for you to share your concerns with us.

As always, we at TD Ameritrade Institutional want to make sure you have a seat at the policy-making table to help ensure the viability of the RIA profession far into the future—for the benefit of you and your clients.

Best regards,

Skip Schweiss
Managing Director, Advisor Advocacy and Industry Affairs
TD Ameritrade Institutional

Introduction

In April, the Securities and Exchange Commission issued three proposals concerning the standards of care for investment advisors and broker-dealers.

RIAs should review and understand these proposals because they may, if finalized, make material changes in the regulation of investment advisors and will introduce a new, and potentially confusing, best interest standard for broker-dealers.

While the RIA Interpretation is consistent with recent statements and enforcement activities by the SEC, it may require changes by RIAs—particularly concerning disclosures of conflicts of interest. The Interpretation is a statement of the SEC's current positions on RIA duties. It would be a tactical mistake to view this only as a proposal and to defer its consideration.

This paper focuses on the RIA Interpretation and its impact on investment advisors. In addition, this paper briefly discusses the proposed Form CRS relationship summaries and highlights some of the provisions that impact RIAs.

It also addresses the question: What should investment advisors do now?

In the interest of brevity, this paper limits its focus to RIA issues in the SEC's proposals. It does not cover all of the SEC's positions in the Interpretation nor, at this time, will we tackle Regulation Best Interest or take an in-depth look at the Client Relationship Summary proposal.

The three parts of the SEC rule "package"

1. **Regulation best interest** – Updates the Securities Exchange Act of 1934, and seeks to enhance the standards of care provided by brokers to retail investors
2. **Client relationship summary (CRS)** – Proposes to establish a new summary disclosure form provided by both brokers and RIAs to their clients
3. **Interpretation of investment advisor standards** – Clarifies the standard of care applicable to RIAs and proposes some new regulations for RIAs

The SEC's RIA Interpretation

While the SEC labels its RIA Interpretation as a proposal, it is actually a compilation of their current views on the duties of RIAs. In other words, if an investment advisor's activities are different than the SEC's Interpretation, now is the time to review and change those practices.

What are the duties of investment advisors from the SEC perspective? The SEC's Interpretation—which covers both SEC- and state-registered investment advisors—lists the following duties for RIAs:

Duty of care

- Duty to provide advice that is in the client's best interest
- Duty to seek best execution
- Duty to act and to provide advice and monitoring over the course of the relationship

Duty of loyalty

- Duty to provide "best interest" advice and the duty of loyalty

Read the full SEC Interpretation

To help with the review, this paper highlights some of the most important positions in the SEC's Interpretation, which can be found at https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08679.pdf.

Duty of care

In its introductory comments, the SEC notes that:

> *An investment advisor is a fiduciary, and as such is held to the highest standard of conduct and must act in the best interest of its clients.*

The SEC also explains that those fiduciary duties cannot be waived or eliminated, by agreement or otherwise:

> *. . . the investment advisor cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty.*

The scope of an investment advisor's fiduciary duty is expansive. As the SEC explains in its Interpretation:

> *This obligation to provide advice that is suitable and in the best interest applies not just to potential investments, but to all advice the investment advisor provides to clients, including advice about an investment strategy or engaging a sub-advisor and advice about whether to roll over a retirement account so that the investment advisor manages that account.*

In explaining the best interest standard, the SEC's starting point is a duty for an advisor to "make a reasonable inquiry into the client's 'investment profile."[1] That investment profile is the foundation upon which advice is to be built. After the appropriate information has been gathered from the client, the SEC mandates that an advisor evaluate the client's investment profile, and the investments and investment strategies, to develop a "reasonable belief" that the personalized advice is "suitable for and in the best interest of the client."

The SEC goes on to explain that in order to have a reasonable belief, an investment advisor would need to consider the risk tolerance of the investor, the potential benefits that might justify the risk, the impact on the investment portfolio relative to the tolerance and risk, and the fees and costs.

While RIAs should study the full proposal—which is only 12 pages long—here are specific examples of issues of importance.

Specific issue: Costs and fees are important factors, but are not, in and of themselves, determinative factors. In that regard, the SEC explains:

> *The cost (including fees and compensation) associated with investment advice would generally be one of many important factors—such as the investment product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions—to consider when determining whether a security or investment strategy involving a security or securities is in the best interest of the client.*

Specific issue: The SEC points out that the recommendation of a more expensive investment may be a violation of the best interest standard of care. In that regard, the SEC says:

> *We believe that an advisor could not reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance.*

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[1] In the RIA Interpretation, the SEC explains that the nature and extent of the inquiry into the investor's information would depend on the services to be rendered. The SEC provides the following example: *"For example, to formulate a comprehensive financial plan for a client, an advisor might obtain a range of personal and financial information about the client, including current income, investments, assets and debts, marital status, insurance policies, and financial goals."*

A close reading of these two examples shows that, where all other factors are identical, and the only difference is cost (e.g., different share classes of a mutual fund), then cost could be a determining factor in a best interest analysis.

Note that the duty of care and the duty of loyalty are distinct requirements and both must be satisfied. While disclosure might cure a conflict of interest under the duty of loyalty, a recommendation still must satisfy the best interest standard considering cost and other relevant factors.

Specific issue: The SEC's position is that a recommendation to roll over a retirement account (e.g., plan benefits or an IRA) to the advisor is a "best interest" recommendation. While the SEC does not describe the information to be evaluated before making that recommendation, there is analogous guidance (from FINRA—Regulatory Notice 13-45, and from the Department of Labor—the vacated Best Interest Contract Exemption). That analogous guidance suggests that investment advisors should, in making rollover recommendations, consider the investments, services, and expenses in both the existing retirement account and the proposed retirement account, in light of the client's investment profile.

While the SEC regards the duty to monitor as a separate duty, it is worth noting that investment advisors have a duty to monitor at intervals that are appropriate for the circumstances. As expressed by the SEC:

> *An investment advisor's duty of care also encompasses the duty to provide advice and monitoring over the course of a relationship with a client. An advisor is required to provide advice and services to a client over the course of the relationship at a frequency that is both in the best interest of the client and consistent with the scope of advisory services agreed upon between the investment advisor and the client.*

It is noteworthy that the duty of care for investment advisors and broker-dealers differ in significant ways with regard to monitoring. Investment advisors have a duty to monitor, unless they contractually agree to limit that duty. However, broker-dealers do not have a duty to monitor unless they contractually agree to do so. In other words, the proposed best interest standard for broker-dealers applies only to securities recommendations and, once the recommendation is made, the broker-dealer no longer owes its customer a best interest duty of care. (Other differences between the best interest standards for broker-dealers and investment advisors are discussed later in this paper.)

Overview of duty of care

The SEC's discussion of the duty to provide best interest advice is consistent with the SEC's current statements and enforcement activities. In that sense, it does not impose an unreasonable additional burden on investment advisors. However, it is likely that future enforcement activities will focus on best interest processes for developing and implementing advice. As a result, RIAs should examine their policies and practices to ensure that they comply with that standard.

Duty of loyalty

In its discussion of the duty of loyalty, the SEC says that “full and thorough” disclosure will cure conflicts of interest:

> *In addition, an advisor must seek to avoid conflicts of interest with its clients and, at a minimum, make full and thorough disclosure of all material conflicts of interest that could affect the advisory relationship. The disclosure should be sufficiently specific so that a client is able to decide whether to provide informed consent to the conflict of interest.*

The SEC goes on to emphasize that disclosures of conflicts of interest must be clear and detailed enough for a client to make a reasonably informed decision to consent to the conflicts or to reject them.

Specific issue: The SEC says that, if an advisor discloses that it “may” have a conflict, it is not adequate disclosure that the conflict actually exists. That is consistent with the current litigation approach taken by the SEC where advisors disclose that they “may” receive 12b-1 fees in addition to their advisory fees. (Also, see the SEC’s Share Class Selection Disclosure Initiative, SCSDI http://www.sec.gov/enforce/announcement/scsd-initiative.)

Conflicts of interest

Both the duty of loyalty and the Form CRS Relationship Summary address conflicts of interest. For example, the duty of loyalty requires that conflicts be adequately disclosed so that investors can make informed decisions about whether to consent, implicitly or explicitly, to the conflict. Similarly, the Form CRS requires that conflicts be disclosed on the Form.

In that regard, the SEC appears to be taking the position that all investment advisors have at least some conflicts.

One SEC example of an advisory conflict is that a recommendation to add assets to an advised account, if accepted, results in higher compensation for an investment advisor. That would include, for example, recommendations to transfer IRAs from other firms and recommendations to participants to take plan distributions and to roll over to an IRA with the investment advisor.

Overview of duty of loyalty

The SEC appears to be taking a more aggressive posture on disclosures of conflicts of interest. As a result, RIAs should closely review their Forms ADV Part 2A to make sure that the disclosures are clear, affirmative, and thorough. In addition, investment advisors may want to comment on the “full and thorough” disclosure position taken by the SEC, and perhaps seek additional guidance on the SEC’s expectations. The concept that disclosure, even though accurate (e.g., “may” receive 12b-1 fees), may be inadequate for informed consent, appears to be an expansion of existing standards or, at the least, appears to conflict with current practices.

While those conflicts may not be obvious, others are. For example, any payments which result partially or entirely, directly or indirectly, from investment recommendations or decisions would be conflicts of interest which must be disclosed. That would likely include all payments from third parties, for example, payments from custodians that are based on recommended transactions.

Differences in investment advisor and broker-dealer proposals

There are three significant differences between the best interest standard of care being proposed for broker-dealers and the best interest standard in the Interpretation for RIAs.

1. **Reg BI best interest standard for broker-dealers applies only to recommendations of securities transactions or investment strategies involving securities transactions.** For example, it does not apply to recommendations of account types, unless accompanied by a securities recommendation. To the contrary, all recommendations made by investment advisors are subject to the best interest standard.

2. **The best interest proposal for broker-dealers only applies to recommendations to "retail customers."** A retail customer is defined as a natural person, or the legal representative of a natural person (for example, a personal trust or an IRA), who uses the recommendation primarily for personal, family, or household purposes. That would exclude, for example, advice to charities, businesses, and retirement plans. On the other hand, the RIA best interest standard applies to all of the advisor's clients.

3. **The best interest standard for broker-dealers would only apply at the time the recommendation is made.** That means that there would not be a legal duty for broker-dealers to monitor the investment recommendations and accounts of their customers. On the other hand, investment advisors have a duty of care to monitor their investment recommendations and accounts at appropriate intervals, unless they contract to limit that responsibility.

Overview of different standards

Unfortunately, while these differences are meaningful, there may be investor confusion. That is because, if these rules are finalized, both broker-dealers and investment advisors will be able to say that they are subject to a best interest standard of care and duty of loyalty. On the surface, those statements will be accurate, but will sound as if the standards are the same. The differences, and their consequences, only become clear when the scope of the duties is understood. As a result, these rules have the potential to create confusion and misunderstanding in the marketplace. However, the disclosures in the proposed Form CRS Relationship Summaries may help explain the differences to investors. See the discussion of those Forms on page 13.

New proposals in the SEC's RIA Interpretation

The SEC's RIA Interpretation also includes a section on new proposals—above and beyond the Interpretation of RIA duties of care. The SEC refers to the proposals as "Areas of Enhanced Investment Advisor Regulation."

Comments on these proposals must be filed on or before Aug. 7, 2018, filed the same as the standard of care proposal described at the beginning of this paper.

SEC's RIA Interpretation proposals

You can find the proposals in the last four pages of the SEC's Interpretation, located at https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/ pdf/2018-08679.pdf.

The three new proposals are:

1. Federal licensing and continuing education

The SEC describes its first proposal as:

> *We request comment on whether there should be federal licensing and continuing education requirements for personnel of SEC-registered investment advisors. Such requirements could be designed to address minimum and ongoing competency requirements for the personnel of SEC-registered advisors.*

In its discussion, the SEC poses specific questions for commenters to answer. Some of the questions are:

- Which advisory personnel should be included in these requirements?
- How many hours of education should be required?
- Should these individuals be required to pass examinations, such as the Series 65 Exam required by most states, or to hold certain designations, as a part of any registration requirement?
- If continuing education requirements are a part of any licensing requirements, should specific topics be required? For example, these individuals could be required to complete a certain amount of training dedicated to ethics, regulatory requirements or the firm's compliance program.
- What other types of qualification requirements should be considered, such as minimum experience requirements or standards regarding an individual's fitness for serving as an investment advisor representative?

In assessing the proposal and these questions, investment advisors need to consider the additional benefits and burdens of the requirements. One "burden" is the cost in time and money involved in satisfying the examination, licensing, and education requirement. On the other hand, examination and continuing education requirements are required by a number of professions, and the benefit may be enhanced professionalism for the advisory community.

2. Provision of account statements

In its discussion of this proposal, the SEC says:

> *We believe that delivery of periodic account statements, if they specified the dollar amounts of fees and expenses, would allow clients to readily see and understand the fees and expenses they pay for an advisor's services. Clients would receive account statements close in time to the assessment of periodic account fees, which could be an effective way for clients to understand and evaluate the cost of the services they are receiving from their advisors.*

The SEC acknowledges that clients may already receive account statements from alternative sources—for example, from custodians, which could result in duplication of effort and expense. Accordingly, the SEC poses its request as follows:

> *We request comment on whether we should propose rules to require registered investment advisors to provide account statements, either directly or via the client's custodian, regardless of whether the advisor is deemed to have custody of client assets under Advisors Act Rule 206(4)-2 or the advisor is a sponsor (or a designee of a sponsor) of a managed account program relying on the safe harbor in Investment Company Act rule 3a-4.*

The SEC then poses a number of more detailed questions, including:

- To what extent do retail clients already receive account statements?
- To what extent do those account statements specify the dollar amounts charged for advisory fees and other fees (e.g., brokerage fees) and expenses?
- Would retail clients benefit from a requirement that they receive account statements from investment advisors?
- What other information would be useful for retail clients to receive on account statements?
- How often should retail clients receive account statements?
- How costly would it be to provide account statements?

Investment advisors should consider those questions and the others asked by the SEC and consider responding to them. It is important that the SEC receive input from investment advisors so that, when and if the final rules are written, they are based on the "real world" experiences of advisors.

3. Financial responsibility

The SEC notes that SEC-registered investment advisors are not subject to net capital requirements, while broker-dealers have capital requirements. The discussion in the RIA Interpretation goes on to say:

> *When we discover a serious fraud by an advisor, often the assets of the advisor are insufficient to compensate clients for their loss. In addition, investment advisors are not required to obtain fidelity bonds unlike many other financial service providers that have access to client assets.*
>
> *In light of these disparities, we request comment on whether SEC-registered investment advisors should be subject to financial responsibility requirements along the lines of those that apply to broker-dealers.*

The SEC asks a number of detailed questions about the need for minimum capital or other financial responsibility requirements, and about fidelity bonds. The SEC also solicits information about the issues related to capital and bonding requirements, such as minimum and adequate amounts. In its discussion, the SEC specifically asks about the North American Securities Administrators Association Minimum Financial Requirements for Investment Advisors Model Rule 202(d)-1.

That model rule requires that an investment advisor who has custody of client funds maintain a minimum net worth of $35,000. In addition, an advisor who has discretionary authority, but not custody, must maintain a minimum net worth of $10,000, as well as other capital requirements. Finally, the SEC asks if advisors should be required to obtain annual audits of their financials.

This proposal obviously imposes burdens and expenses for investment advisors. As a result, it's important that advisors express their opinions through comments to the SEC.

SEC's questions regarding financial responsibility

- Is there a need for minimum capital or financial responsibility requirements?
- Is there a need for fidelity bonds?
- Should advisors be required to obtain annual audits for their financials?

Form CRS relationship summary

The SEC is also proposing that broker-dealers and investment advisors deliver relationship summaries to "retail investors" at the beginning of their relationships.

For example, the investment advisor Form CRS would be delivered before or at the time the RIA firm enters into an investment advisory agreement with a retail investor. The form would also be filed with the SEC. In addition, the form will need to be updated and delivered to existing clients when material changes occur.

The relationship summary must be no more than four pages long, or an equivalent limit, if in an electronic format. The Form CRS would have to contain the following sections:

- Introduction
- The relationships and services the firm offers to retail investors
- The standard of conduct applicable to those services
- The fees and costs that retail investors will pay
- Comparisons of brokerage and investment advisory services (for stand-alone broker-dealers and investment advisors)
- Conflicts of interest
- Where to find additional information about the firm, including whether the firm and its financial professionals currently have reportable legal or disciplinary events and who to contact about complaints
- Key questions for retail investors to ask the firm's financial professional

For these purposes, a "retail investor" is defined as a prospective or existing client, who is a natural person (that is, an individual). All natural persons would be included in the definition, regardless of the individual's net worth. The definition would also include a trust or similar entity that represents natural persons.

Since the subject matter of the form is mandated, and much of the content and presentation is specified in the form's instructions, advisors should review the forms and comment on them.

The SEC's proposed guidance on the form CRS relationship summaries is lengthy (over 150 pages of fine print), and the SEC asks for answers to over 200 questions. As a result, a comprehensive discussion of the form CRS proposal is beyond the scope of this paper.

In addition, the SEC and other investor organizations are doing market testing on whether investors understand the information in the forms and whether it will have an impact on investor conduct. As a result, it is possible that the CRS forms will be revised and reissued for comments. Investment advisors should, at the least, review the Form CRS proposed for RIAs, together with the instructions, and decide whether to comment on those.

Restrictions on the use of "advisor" and "adviser":

The SEC has determined that certain names and titles used by broker-dealers, including "financial advisor," contribute to retail investor confusion and, as a result, could mislead investors into believing that they are engaging an investment advisor, when they are not. That, in turn, could mislead retail investors into believing that they will receive services typical of investment advisors, when they have engaged a broker-dealer and will not be receiving those services (for example, monitoring of account and fiduciary responsibility for all recommendations).

As a result, the SEC proposes to limit the use of the terms "advisor" and "adviser." More specifically, the proposal is that only investment advisors can use the words "advisor" or "adviser."

While that distinction works well when comparing a stand-alone registered investment advisor with a stand-alone broker-dealer, the SEC position is more confusing when applied to a dual-registrant broker-dealer/RIA. That is because dually registered firms (that is, firms registered as both a broker-dealer and an investment advisor) would be allowed to use "advisor" and "adviser" in the names or titles of the representatives, so long as the representative is both an individual advisor representative and a registered representative of the broker-dealer.

What do you think?

Share your thoughts on this new SEC guidance.

Take this short survey

Form CRS links

- An investment advisor Form CRS mock-up is at: https://www.sec.gov/rules/proposed/2018/34-83063-appendix-e.pdf
- The instructions for the Form CRS are at: https://www.sec.gov/rules/proposed/2018/34-83063-appendix-b.pdf.

Conclusion

The SEC's RIA Interpretation is more than just a proposal. It is, in the SEC's words, a "reaffirmation" and a "clarification" of "certain aspects of the fiduciary duty that an investment advisor owes to its clients."

As a result, investment advisors need to understand the SEC's views, as expressed in the Interpretation, and ensure that their practices are consistent with those views.

Next steps: What should RIAs do now?

First and foremost, investment advisors should review and understand the SEC's RIA Interpretation. Then, if they wish to express their views, they should **submit comments to the SEC on or before August 7, 2018.**

To file comments on the SEC's RIA interpretation:

ELECTRONIC COMMENTS:

Use the Commission's internet comment form:
http://www.sec.gov/rules/interp.shtml

Email to: rule-comments@sec.gov

*Include **File Number S7–09–18** in the subject line*

PAPER COMMENTS:

Send to: Brent J. Fields
Secretary, Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

*Refer to **File Number S7-09-18***

To provide feedback on the SEC Form CRS proposal:

ELECTRONIC COMMENTS:

Email to: rule-comments@sec.gov

*Include **File Number S7-08-18** in the subject line*

PAPER COMMENTS:

Send to: Brent J. Fields
Secretary, Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

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About the author

Fred Reish of Drinker Biddle & Reath LLP represents clients in fiduciary issues, prohibited transactions, tax-qualification, and Department of Labor, Securities and Exchange Commission, and FINRA examinations of retirement plans and IRA issues.

Fred works with both private and public sector entities and their plans and fiduciaries and represents plans, employers, and fiduciaries before federal agencies such as the DOL and IRS. He consults with banks, trust companies, insurance companies, and mutual fund management companies on 401(k) recordkeeping services, investment products, and issues related to plan investments and retirement income. He also represents broker-dealers and registered investment advisors on issues related to fiduciary status and compliance, prohibited transactions, and internal procedures.

His experience also includes advising insurance companies and investment managers of the development of products and services that are consistent with ERISA's fiduciary standards and prohibited transaction restrictions, including retirement income investments and guarantees.

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