

MEMO# 34253

August 15, 2022

SEC Staff Issues Guidance on Standards of Conduct for Advisers and Broker-Dealers Regarding Conflicts of Interest

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TO: ICI Members

Broker/Dealer Advisory Committee

Chief Compliance Officer Committee

Investment Adviser and Broker-Dealer Standards of Conduct Working Group

Investment Advisers Committee

Pension Committee

Pension Operations Advisory Committee

SEC Rules Committee SUBJECTS: Compensation/Remuneration

Disclosure

Distribution

Fees and Expenses

Intermediary Oversight

Pension RE: SEC Staff Issues Guidance on Standards of Conduct for Advisers and Broker-Dealers Regarding Conflicts of Interest

The staff of the Securities and Exchange Commission recently issued a Staff Bulletin providing guidance on the application of standards of conduct relevant to broker-dealers and investment advisers in identifying and addressing conflicts of interest.^[1] The Staff Bulletin discusses the applicability of Regulation Best Interest ("Reg BI") for broker-dealers and the fiduciary duty standard for investment advisers under the Investment Advisers Act of 1940 (the "IA fiduciary standard"). The staff notes that both standards include an obligation to act in a retail investor's best interest. While the staff clarifies that its guidance is not a "rule, regulation, or statement of the Commission," the Staff Bulletin provides important insights into the staff's views on how broker-dealers and advisers should identify and address conflicts of interest in light of the SEC's adoption of Reg BI and of an interpretation of the IA fiduciary standard in 2019.^[2] The Staff Bulletin is summarized below.

Identifying Conflicts of Interest

The SEC staff believes that all broker-dealers, investment advisers, and financial

professionals have conflicts of interest. Examples of conflicts of interest include compensation, revenue, or other benefits (financial or otherwise):

- to the firm or its affiliates, including fees and other charges for services provided to retail investors (e.g., compensation based on assets gathered and/or products sold, such as receipt of assets under management (AUM) or engagement fees, commissions, markups, payment for order flow, cash sweep programs, or other sales charges) or payments from third parties whether or not related to sales or distribution, including sub-accounting or administrative services fees paid by a fund or revenue sharing);
- to financial professionals from their firm or its affiliates (e.g., compensation or other rewards associated with quotas, bonuses, sales contests, special awards; differential or variable compensation based on the product sold, accounts recommended, AUM, or services provided; incentives tied to appraisals or performance reviews; forgivable loans based upon the achievement of specified performance goals related to asset accumulation, revenue benchmarks, client transfer, or client retention)
- resulting from other business or personal relationships the financial professional may have, relationships with third parties that may relate to the financial professional's association or affiliation with the firm or with another firm (whether affiliated or unaffiliated), or other relationships within the firm (e.g., gifts, entertainment, meals, travel, and related benefits, including in connection with the financial professional's attendance at third-party sponsored trainings and conferences); and
- to the firm or its affiliates resulting from the firm's or its financial professionals' sales or offer of proprietary products or services, or products or services of affiliates.

Broker-dealers and investment advisers have an obligation to identify conflicts of interest. The staff details several non-exhaustive steps that broker-dealers and investment advisers should consider to identify conflicts of interest, including defining conflicts in a manner that is relevant to the firm's business, defining conflicts in a manner that includes conflicts that arise across the scope of advice or recommendations associated with the relationship with the retail investor, establishing a process to identify the types of conflicts the firm and its financial professionals may face and how those conflicts might affect advice or recommendations, providing for an ongoing and regular periodic process to identify conflicts, and establishing and documenting training programs regarding conflicts of interest. The staff emphasizes that a culture of compliance is critical to effectively identifying conflicts within a firm.

Merely identifying conflicts of interest does not satisfy an investment adviser's or broker-dealer's obligation to act in a retail investor's best interest—the staff notes that some conflicts should, and in some cases must, be addressed through mitigation.

Eliminating Conflicts of Interest

The staff explains that there are circumstances when a particular conflict should be eliminated. Broker-dealers and investment advisers have an obligation to act in the retail investor's best interest, including, when appropriate, eliminating conflicts. Investment advisers must fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent. If the client cannot provide informed consent because, for example, the conflict is of a nature and extent that would make it difficult for the adviser to provide full and fair disclosure, and the investment adviser cannot mitigate the conflict such that full and fair disclosure and informed consent are possible, the staff believes that the adviser should eliminate the conflict.

Firms also may find that there are some conflicts that they are unable to address in a way that would allow the firm or its financial professionals to provide advice or recommendations that are in the retail investor's best interest. In such cases, firms may need to determine whether to eliminate the conflict or refrain from providing advice or recommendations that could be influenced by the conflict to avoid violating the obligation to act in the retail investor's best interest. The staff believes that "the greater the reward to the financial professional for meeting particular thresholds (or conversely, the more severe the consequence for failing to meet them), the greater is the concern whether the incentive program complies with Reg BI and the IA fiduciary standard."

Mitigating Conflicts of Interest

The staff believes that appropriate measures to mitigate conflicts will depend on "the nature and significance of the incentives provided to the firm or its financial professionals and a firm's business model." Factors that are relevant to a firm's approach to mitigating conflicts of interest include, among others:

- the sources of the firm's compensation, revenue, or other benefits (financial or otherwise), whether or not it receives them directly from the retail investor;
- the extent to which a firm's revenues vary based on the type of account, products (e.g., share classes recommended), services recommended, or AUM;
- whether or not the firm or its affiliates recommend or provide advice about proprietary products;
- the extent to which the firm uses incentives to encourage financial professionals to recommend or provide advice about accounts or investment products that are more profitable for the firm;
- the extent to which the compensation of financial professionals varies based on the investment product recommended (e.g., variable compensation for similar securities);
- the nature of the payment structure for financial professionals (e.g., whether retrospective, the steepness of the increases between levels);
- the size or structure (e.g., broker-dealer, investment adviser, or dual registrant) of the firm or if the firm's financial professionals are dually licensed or engage in activities outside of the firm;
- whether the firm shares dually licensed financial professionals with affiliates or third parties;
- retail investor base (e.g., diversity of investment experience, total assets, and financial needs); and
- the complexity of the security or investment strategy involving securities that are recommended.

The staff believes that firms have an obligation to address conflicts of interest raised by the compensation arrangements of their financial professionals, and notes that, in some cases, to avoid violating the obligation to act in a retail investor's best interest a firm may be required to eliminate a conflict or refrain from providing advice or recommendations that are influenced by the conflict. The staff notes that Reg BI explicitly requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and mitigate conflicts of interest at the associated person level. The staff asserts that investment advisers also should consider having such policies and procedures to avoid violations of the IA fiduciary standard.

The staff provides examples of types of conflicts of interest that may arise from compensation practices for financial professionals, as well as examples of practices that may be used as potential mitigation methods for firms to comply with their obligations to

retail investors, including:[\[3\]](#)

- avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales of certain products or provision of certain services;
- minimizing compensation incentives for financial professionals to favor one type of account over another, or to favor one type of product over another (e.g., products that provide third-party compensation, such as revenue sharing, proprietary or preferred provider products, or comparable products sold on a principal basis), for example by basing differential compensation on neutral factors;
- eliminating compensation incentives within comparable product lines by, for example, capping the credit that financial professionals may receive across mutual funds, annuities, real estate investment trusts ("REITs"), or other comparable products across providers;
- implementing supervisory procedures to monitor recommendations or ongoing advice that result in additional compensation that: is near compensation thresholds; is near thresholds for firm recognition; or involve higher compensating products, proprietary products, or transactions that provide more compensation to the firm or financial professional;
- adjusting compensation for financial professionals who fail to manage their conflicts of interest adequately and to bring any conflicts to management's attention;
- limiting the types of products, transactions, or strategies certain financial professionals may recommend; and
- providing training and guidance to financial professionals on evaluating, selecting, and, as required, monitoring investments in the best interests of retail investors.

Product Menus

The staff confirms that firms must address conflicts of interest concerning a recommendation or advice that is limited to a menu of certain products. Limitations on product menus, including offering only proprietary products, a specific asset class, or products that pay revenue sharing or feature similar third-party arrangements, must comply with a firm's obligations to act in the best interest of retail investors. The staff recommends that firms engage in a "product review" to evaluate whether a limited product menu creates a conflict of interest. A product review process could include, for example:

- identifying and mitigating the conflicts of interest associated with the product;
- declining to recommend or provide advice with regard to a product where the firm cannot effectively mitigate the conflict;
- evaluating the use of "preferred lists;"
- restricting the retail investors to whom certain products may be recommended; prescribing minimum knowledge and/or training requirements for financial professionals who may provide recommendations or advice with regard to certain products; and
- conducting periodic product reviews to identify potential conflicts of interest, whether the measures addressing conflicts are working as intended, and to modify the measures or product selection accordingly.

The staff reminds firms that, under Reg BI, broker-dealers must also identify and disclose any material limitations placed on securities or investment strategies that may be recommended to retail customers and related conflicts of interest. The staff believes firms could also apply a product review process to limitations placed on investment strategies and investment advisers, including in situations where an adviser's advice is limited to

products offered through an affiliate.

Disclosing Conflicts of Interest

The staff explains that disclosures should be specific to each conflict, in "plain English," and tailored to, among other things, firms' business models, compensation structures, and the products they offer. The staff emphasizes that stating that a firm "may" have a conflict is insufficient if the conflict actually exists. Furthermore, the nature and extent of some conflicts may make them difficult to convey effectively to retail investors. The staff believes firms should consider mitigating or eliminating conflicts that cannot be "fully and fairly disclosed."

The staff provides examples of facts relating to conflicts of interest associated with compensation or benefits that should be disclosed to retail investors including:

- the nature and extent of the conflict;
- the incentives created by the conflict and how the conflict affects or could affect the recommendation or advice provided to the retail investor;
- the source(s) and scale of compensation for the firm and/or financial professional; how the firm and/or financial professional is compensated for, or otherwise benefits from, their recommendation or advice and what, if any additional benefits they may receive; and
- the nature and extent of any costs or fees incurred, directly or indirectly, by the retail investor as a result of the conflict.

When broker-dealers and investment advisers are recommending or providing advice about proprietary products, facts regarding conflicts of interest that should be disclosed may include:

- whether the firm or an affiliate manages, issues, or sponsors the product;
- whether the firm, its financial professionals or an affiliate could receive additional fees and compensation related to that product;
- whether the firm prefers, targets, or limits its recommendation or advice to proprietary products or only those proprietary products for which the firm or an affiliate could receive additional fees and compensation; and
- the extent to which financial professionals receive additional compensation, have quotas to meet, or qualify for bonuses or awards based on their sale of proprietary products (such as mutual funds, annuities, or REITs).

When a conflict is created as a result of a firm or its financial professionals receiving compensation from third parties, whether or not sales-related (e.g., revenue sharing, sub-accounting, or administrative services fees paid by a fund or its adviser), broker-dealers, investment advisers, or their financial professionals should disclose the existence and effects of such incentives provided to the firm or shared between the firm and others. The staff notes the following examples of third-party compensation incentives that broker-dealers and advisers may have:

- offering a limited product menu from which recommendations are made or advice is provided based on preferred providers or investments;
- agreements to receive payments from a clearing broker for recommending that the adviser's clients invest in no-transaction-fee or sales load mutual fund share class offered on the clearing broker's platform;
- any agreements to receive payments, loan forgiveness, and/or expense offsets from a

custodian for recommending that the firm's retail investor maintain assets at the custodian; and

- any arrangements where the firm is compensated by mutual funds, exchange-traded funds, or other financial products out of product fees or by the products' sponsors, or other revenue-sharing arrangements.

The staff notes that, when recommending wrap fee and other separately managed account programs, firms should disclose facts that could encourage the broker-dealer or investment adviser to recommend such an account.

Finally, the staff emphasizes that identifying and addressing conflicts is not a "set it and forget it" exercise. Firms should monitor conflicts over time and assess periodically the adequacy and effectiveness of their policies and procedures to help ensure continued compliance with Reg BI and the IA fiduciary standard. Importantly, the staff believes that, to demonstrate compliance under both Reg BI and the IA fiduciary standard, a firm should consider documenting the measures it takes to address and monitor conflicts of interest.

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endnotes

[1] See Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest (August 3, 2022), available at <https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest> ("Staff Bulletin"). The SEC staff previously issued a bulletin in March focusing on the application of these standards of conduct to account recommendations to retail investors. See Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (March 30, 2022), available at <https://www.sec.gov/tm/iabd-staff-bulletin>.

[2] See Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031, 84 Fed.Reg. 33318 (June 5, 2019), available at <https://www.sec.gov/rules/final/2019/34-86031.pdf> ("Reg BI Adopting Release"); Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 84 Fed.Reg. 33669 (June 5, 2019) available at <https://www.sec.gov/rules/interp/2019/ia-5248.pdf> ("Fiduciary Interpretation").

[3] The staff asserts that, to satisfy their obligation to act in a retail investor's best interest, firms "also must address conflicts at the firm level."

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