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May 3, 2023

SEC Staff Issues Bulletin on Regulation Best Interest and Fiduciary Duty Care Obligations

[35277]

May 03, 2023

TO: Investment Company Directors
Broker/Dealer Advisory Committee
Investment Adviser and Broker-Dealer Standards of Conduct Working Group
Investment Advisers Committee
Operations Committee
Pension Committee
SEC Rules Committee
Transfer Agent Advisory Committee
SUBJECTS: Compliance
Disclosure
Investment Advisers
Operations RE: SEC Staff Issues Bulletin on Regulation Best Interest and Fiduciary Duty Care Obligations

On April 20, 2023, the Securities and Exchange Commission ("Commission" or SEC) staff issued a third staff bulletin ("Staff Bulletin")[\[1\]](#) providing guidance on the duty of care obligations under Regulation Best Interest ("Reg BI") for broker-dealers and under the fiduciary duty standard under the Investment Advisers Act of 1940 (the "IA fiduciary standard") for investment advisers when providing recommendations or advice to retail investors.[\[2\]](#) It is noteworthy, that for purposes of the Staff Bulletin, the SEC staff largely conflates the care standards for broker-dealers and investment advisers, referring to them collectively throughout the Bulletin as "care obligations," and treating them identically. As the Staff Bulletin notes, "[a]lthough the specific application of Reg BI and the IA fiduciary standard may differ in some respects and be triggered at different times, in the staff's view, they generally yield substantially similar results in terms of the ultimate responsibilities owed to retail investors."[\[3\]](#)

The staff specifies that the care obligations generally include three overarching and intersecting components which are: (1) understanding the potential risks, rewards and costs associated with an investment strategy; (2) having a reasonable understanding of the retail investor's profile; and (3) based on an understanding of the first two elements, as well

as, in the staff's view, a consideration of reasonably available alternatives, having a reasonable basis to conclude that the recommendation or advice is in the retail investor's best interest. Further, the Staff Bulletin asserts that "[w]hether a recommendation or advice satisfies the care obligations is an objective evaluation, turning on the facts and circumstances of the particular recommendation or advice and the investment profile of the particular retail investor at the time the recommendation is made or when the advice is provided."

After the introductory background, the Staff Bulletin includes 20 questions and answers and is divided into five parts, a summary of which is provided below.

Understanding the Investment

Broker-dealers, investment advisers and their financial professionals need to understand a product before selling it. The Staff Bulletin provides that under the care obligations, firms and their financial professionals need to understand the products they are selling and their investment strategies before advising on or recommending them to retail investors. The staff notes that this includes "developing a sufficient understanding of the potential risks, rewards, and costs of the investment or investment strategy to have a reasonable basis to believe that the recommendation or advice could be in a retail investor's best interest."

The Staff Bulletin next offers a list of factors that should consider as part of evaluating an investment strategy. These considerations include: (1) the objectives of the investment or investment strategy; (2) the initial and ongoing costs; (3) the investment strategy's key characteristics and risks, or other features that may impact the investment; (4) performance; (5) expected returns, expected payout rates, and potential losses; (6) any special or unusual features of the investment or investment strategy; and (7) the role of the investment or investment strategy within the context of the retail investor's actual or anticipated investment portfolio.

While a firm or financial professional cannot satisfy its care obligations merely by recommending the lowest cost option, the staff emphasizes that costs should always be considered in a recommendation. The staff adds that the firm and financial professional must consider the total potential costs to the retail investor, including the direct and indirect costs of the investment (e.g., commissions, markups or markdowns, transaction costs, sales loads or charges, advisory or management fees, and all transaction fees and possible penalties). Additionally, financial professionals should not rely on an approved list of investments for retail investors to meet their care obligations. Rather than depending on the efforts of others at their firm, the professional is personally responsible for understanding a product before he or she recommends it to investors.

Understanding the Retail Investor's Investment Profile

As part of the care obligations, the staff expects a firm or its financial professionals to be familiar with an investor's investment profile. The Staff Bulletin defines "investment profile" as the information a firm or financial professional should make reasonable efforts to learn about a retail investor. Obtaining this information is a critical step in satisfying the care obligations. In the staff's view, firms and their financial professionals should obtain information about "the investor's 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 objective and financial goals; and any other information the retail investor may disclose to you in connection with

the recommendation or advice."

Further, the staff believes that gathering information for a client's investment profile is not a one-time obligation and that the profile should be periodically updated to account for changes in circumstances and life events such as marriage, divorce, birth of child and retirement or if there are inconsistencies in the account (e.g., conflicting investment objectives). If sufficient information is unavailable to complete the investment profile, the financial professional should decline to provide advice or recommendations or document why such information is not relevant in light of the facts and circumstances.

The Staff Bulletin also highlights that a client's tax status and its implications may be important considerations. The staff states that firms and their financial professionals should consider whether a tax-advantaged option (such as 529 plans, tax loss harvesting, opportunity zone funds, donor-advised funds, direct and custom indexing, variable annuities, government securities, 401(k) accounts, and IRAs) may be appropriate when assessing investment options that are in the best interest of the investor.

Considering Reasonably Available Alternatives

The Staff Bulletin sets the expectation that firms and their financial professionals should consider reasonably available alternatives when recommending or providing advice about investments or investment strategies to retail investors.[\[4\]](#) The staff believes that consideration of reasonable alternatives should begin early in the process of forming a recommendation and that the firm or financial professional should conduct a comparative assessment of alternatives in order to identify investments that are in the retail investor's best interest (e.g., merely comparing share classes of the same mutual fund is not enough).

Generally, the staff believes firms should have a process to identify the scope of reasonably available alternatives that financial professionals should evaluate. Ideally, this process should start with considering a broader array of investment options that are consistent with the client's investment profile, and then narrowing those options to a smaller universe of potential investments as the analysis becomes focused on meeting the best interest of a particular retail investor. In the staff's opinion, firms should have a reasonable process, tailored to their particular business model and investment offerings, for evaluating alternatives. This process should include guidance (e.g., policies and procedures, employee training) for the firm's financial professionals that defines the scope of alternatives that should be considered and the factors that should be weighed (e.g., costs, potential benefits and risks as well as compatibility with the retail investor's investment profile) in evaluating the available alternatives.

For firms with an open architecture framework, the staff does not intend for financial professionals to consider every possible alternative available at the firm. The staff stresses, however, that financial professionals would still need to evaluate a range of investments sufficient to provide a reasonable basis to believe a recommendation or advice is in the best interest of the retail investor.

For firms with a limited investment menu, the staff expects financial professionals to be familiar with each investment option available to investors. The Staff Bulletin notes, "[C]ertain investments on that limited menu that can be made available to retail investors in general may be inconsistent with an individual retail investor's investment profile, such that the investments are not reasonable alternatives for that particular retail investor." Significantly, the staff articulates that a financial professional cannot satisfy his or her care

obligations by simply recommending or providing advice on the "most appropriate" available option from among the firm's limited menu of investments. Instead, the staff states that one possible outcome of such a process is that the firm or financial professional may conclude that no investment or investment strategy the firm offers is in the retail investor's best interest.

The Staff Bulletin also provides examples of when products that are not identical may still be considered comparable for purposes of identifying them as reasonably available alternatives based on the retail investor's investment profile (e.g., considering different types of products that provide the same market exposure). The staff advises firms and their financial professionals to consider the potential risks, rewards, and costs when recommending or providing advice on investments in order to have a reasonable basis to believe that a recommendation or advice is in a retail investor's best interest. The staff recognizes that there is no legal requirement to document the consideration of alternatives but believes it would be difficult to demonstrate such considerations without documentation that a financial professional reasonably considered alternatives.

Special Considerations: Complex or Risky Products

The staff acknowledges that the care obligations do not prevent firms and their financial professionals from recommending complex or risky products but said that they must establish "a reasonable basis to believe the complex or risky product is in the best interest of the retail investor." The staff believes that "firms and financial professionals should consider whether less complex, less risky or lower cost alternatives can achieve the same objectives for their retail customers as part of their overall reasonable basis analysis." Likewise, firms generally should apply "heightened scrutiny" to whether a risky or complex product is in the retail investor's best interest and they should have policies and procedures tailored to the firm's business, training and supervision with respect to the recommendation of risky products.

Special Considerations: Recommendations and Advice by Dual Registrants

For circumstances where a retail investor holds both brokerage and advisory accounts at the same firm, the staff believes a dually registered firm or dually licensed financial professional should consider whether an investment recommendation is better suited for the investor's brokerage account or advisory account. In the words of the staff, "this process should include consideration of the difference in reasonably expected total costs depending on whether the investment or investment strategy is held in the retail investor's brokerage or advisory account, including but not limited to any account level costs, such as commissions, advisory fees on assets under management, or, as relevant, tax consequences, over the expected life of the investment." The Staff Bulletin offers an example where a retail investor, whose objective is to buy and hold a long-term investment, may be better off paying a one-time commission to a broker-dealer for the purchase of that investment rather than paying an ongoing advisory fee merely to hold the same investment.

Conclusion

In the staff's view, a general check-the-box process is unlikely to fulfill the care obligations. The staff suggests that its bulletin should be read in combination with Reg BI and the specific Commission releases discussing Reg BI and the IA fiduciary standard. In addition, the Staff Bulletin notes that the staff has made available other resources, including staff

FAQs, risk alerts and other releases highlighting compliance practices and staff observations. Nevertheless, the staff clarifies that Staff Bulletin and other staff documents (including those cited within the Staff Bulletin) represent the views of the staff of the Commission and are not a rule, regulation, or statement of the Commission.

The Staff Bulletin follows the Commission's recent focus on enforcement of Reg BI.^[5] Notably absent from the Staff Bulletin is a discussion of care obligations for robo-advisers and hybrid advisers (i.e., robo-advisers offering varying levels of human interaction to their clients).^[6]

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Notes

[1] See Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations (April 20, 2023), available at <https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers> ("Staff Bulletin"). The SEC staff previously issued a bulletin in August providing guidance on the application of standards of conduct relevant to broker-dealers and investment advisers in identifying and addressing conflicts of interest. 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>. Prior to that, the SEC staff 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>. The SEC staff has also issued FAQs on Reg BI, which are available at <https://www.sec.gov/tm/faq-regulation-best-interest>.

[2] The SEC adopted Reg BI, along with an Interpretation Regarding Standard of Conduct for Investment Advisers, in June 2019 as part of its standards of conduct rulemakings. For a detailed summary of the SEC's rulemakings, please see the attachments to ICI Memorandum No. 31815 (June 19, 2019), available at <https://www.ici.org/memo31815>.

[3] The Staff Bulletin further notes that "[a]lthough an investment adviser's fiduciary duty applies to all advisory clients (whether retail investors or otherwise) and applies to the entire advisory relationship, the adviser's duties when providing advice to retail investors is the focus of this bulletin. Reg BI's obligation to act in the best interest of the retail customer, however, applies only when making a recommendation of a security or investment strategy involving securities (including account recommendations) to a retail customer for personal, family, or household use." Staff Bulletin at n.3.

[4] Notably, the staff cites to settled enforcement actions against investment advisers for failing to consider certain available lower cost alternatives when selecting or recommending investments for their clients. These settled enforcement actions involved alleged breaches of fiduciary duty by the adviser in connection with higher cost mutual fund share class or cash sweep vehicle selection resulting in revenue sharing being paid to the adviser or its affiliate. See O.N. Investment Management Company, Investment Advisers

Act Release No. 5944 (Jan. 11, 2022), Rothschild Investment Corp., Investment Advisers Act Release No. 5860 (Sept. 13, 2021) and Cowen Prime Advisors, LLC, Investment Advisers Act Release No. 5874 (Sept. 27, 2021).

[5] See <https://www.sec.gov/news/press-release/2022-110>.

[6] The staff last provided guidance for robo-advisers in a 2017 IM Guidance Update. See <https://www.sec.gov/investment/im-guidance-2017-02.pdf>.

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