SEC Staff Posts Conflicts of Interest Guidance for Broker-Dealers and Investment Advisers

Alert
08.30.2022

By Eric Mikkelson and Asma Ali

On August 3, 2022, the Securities and Exchange Commission (SEC) staff published a Q&A-Styled Bulletin focused on conflicts of interest under the Investment Advisers Act of 1940 (Advisers Act) and Regulation Best Interest (Reg BI) under the Securities Exchange Act of 1934 (Exchange Act). Although the Bulletin, in the staff's view, merely reiterates the standards of conduct for investment advisers and broker-dealers under the Acts, it appears to heighten the requirements and standards of care beyond what was previously expected. A summary of the Bulletin is provided below.

IDENTIFYING CONFLICTS OF INTEREST

The SEC staff unequivocally states that "all broker-dealers, investment advisers and financial professionals" have conflicts of interest—a position they have never explicitly taken before. The SEC explains that addressing conflicts of interest is not merely a "check the box" task, but rather requires a thorough ongoing process. Part of this ongoing process is the requirement that broker-dealers and investment advisers not only have an initial conflicts identification process but that they have an ongoing process in the event that conflicts later arise and are required to periodically review their policies and procedures to ensure compliance with Reg BI.

The SEC staff also makes it clear that identifying and disclosing conflicts of interest to retail investors is not enough to satisfy the obligations under Reg BI and the Advisers Act—rather certain conflicts should or must be addressed through mitigation. Where the conflict cannot be mitigated, firms must decide whether to eliminate the conflict or refrain from providing advice or recommendations. However, even if the conflicts of interest are sufficiently addressed and mitigated, a firm may only provide its services if it believes it to be in the best interest of the retail investor.

ELIMINATING AND MITIGATING CONFLICTS OF INTEREST

Investment advisers must disclose a conflict of interest to a client in a way that the client can provide informed consent. If the investment adviser is unable to obtain true informed consent from the client—either because the type of disclosure required to obtain true informed consent would impede on the investment adviser's ability to carry on the transaction or would violate another agreement—then full and fair disclosure and consent are not achievable and the adviser must eliminate such conflict if it wishes to proceed. One particular area the SEC staff highlights is incentive programs. In the staff's view, the greater or more severe the reward or punishment to the financial professional for meeting or missing particular thresholds, the greater the chance that the incentive program violates the fiduciary standards under Reg BI and the Advisers Act.

The Bulletin makes clear that there are circumstances where the only way a conflict of interest can be mitigated is by eliminating the conflict entirely. This situation occurs when firms are unable to address a conflict in a way that allows the firm to provide advice or recommendations that are in the retail investor's best interest. Elimination of a conflict of interest may also be required if it involves compensation related conflicts. The SEC staff makes clear that all firms need to address compensation related conflicts and they should do so by assessing the following questions as a baseline:

- Does the firm's compensation practice incentivize its financial professionals to offer advice or recommendations that are not in the retail investors' best interest?
- Does the basis for calculating financial professionals' compensation have the effect of passing along firm-level conflicts to their financial professionals, such as incentivizing financial professional to recommend or provide advice about certain products, account types, or services to investors that are most profitable for the firm?
- Do the firm's financial professionals receive other types of compensation or benefits (such as trips or meals paid for by a third party) that may create conflicts of interest between the financial professionals and the firm's retail investors—and does the firm have policies, procedures and other systems in place to identify and address any such conflicts?

The Bulletin also sets out a non-exhaustive list of practices that could be used as mitigation methods, including:

- Avoiding compensation thresholds that disproportionately increase compensation with incremental increases in sales of certain products or provision of 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
- 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 SEC staff believes that firms should carefully consider how their product menu choices—such as offering only proprietary products, a specific asset class, or products that pay revenue sharing or feature similar third-party arrangements—comply with the firm's obligations to act in the best interest of its retail investors. The SEC staff believes that firms should evaluate whether a limited product menu creates conflicts and recommends establishing product review process for the products they offer. The SEC staff's recommendation that firms establish a product review process because limited product menus are evidence of a conflict is arguably at odds with the Adopting Release for Reg BI which expressly allows for limited product sets. The Bulletin also expands Reg BI's requirement that broker-dealers disclose material limitations on product offerings and, in the SEC staff's view, the product review processes could equally apply to limitations placed on investment strategies and investment advisers.

DISCLOSING CONFLICTS OF INTEREST

The SEC staff makes clear that disclosing conflicts of interest is not merely a "check the box" exercise. The staff believes that disclosures should be in plain English, specific to each conflict, and narrowly tailored to, among other things, the firms' business models, compensation structure, and products offered at different firms. It is also not sufficient to state that a firm "may" have a conflict when the conflicts actually exists. If the conflict concerns compensation or other benefits, the disclosure should, at a minimum, describe the nature and extent of the conflict; the incentives created by the conflict and how the conflict could affect the recommendation or advice provided to the retail investor; the source and scale of the compensation; how

the firm and/or financial professions benefit from their recommendation and advice; and the nature and extent of any cost or fees incurred by the retail investor as a result of the conflict, whether directly or indirectly.

The Bulletin goes into more specific detail regarding disclosure requirements when recommending wrap fee and other separately managed account programs, when providing advice about or recommending proprietary products to retail investors, and third party compensation. The SEC staff emphasizes that identifying and addressing conflicts of interest is not a "set it and forget it" exercise, but rather one that requires constant monitoring and periodic assessment of the adequacy and efficiency of the policies and procedures put in place to help ensure continued compliance with Reg BI and the Advisers Act fiduciary standard.

This Bulletin is part of the SEC's growing effort to have all facets of the financial industry enhance environmental, social and governance disclosures. Shortly after the SEC posted this Bulletin, it proposed rules under the Exchange Act aimed at improving the governance of registered clearing agencies by imposing requirements that would restrict the potential of conflicts of interest influencing the board of directors of a registered clearing agency. Before that this year, the SEC introduced various other proposals including the "Names Rule" (Rule 35d-1) under the Investment Company Act of 1940 and changes to the rules and forms under both that and the Advisers Act. With the SEC's latest moves, firms will be best positioned by having thorough and continuous processes in place for identifying, monitoring, and addressing conflicts of interest.

CONTACTS

Asma S. Ali

Eric T. Mikkelson

RELATED CAPABILITIES

Banking & Financial Services

Corporate Finance

Investment Management

Private Business