Professional Perspective

Reading Between the Lines of the SEC Staff's Care Obligation Bulletin

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The SEC staff issued a Bulletin recently that provides guidance regarding the care obligations applicable to broker-dealers under Regulation Best Interest and investment advisers under the Investment Advisers Act of 1940 fiduciary standard. The bulletin follows similar staff guidance concerning Account Recommendations for Retail Investors from March 2022 and Conflicts of Interest from August 2022.

Although SEC staff bulletins have no legal force or effect, there are some important takeaways and suggestions of heightened responsibilities imbedded in the areas outlined by the staff.

Understand All Recommended Products & Strategies

By featuring the issue prominently in the first Q&A of the bulletin, the staff emphasizes that "[u]nder the care obligations, investment advisers, broker-dealers, and their financial professionals need to understand the investments and investment strategies on which they provide advice and recommendations before advising on or recommending them to retail investors."

The staff's emphasis on the expectation that financial professionals understand products before making recommendations suggests that in some instances, firms or financial professionals have attempted to retroactively document their understanding of products, and that such practice will be given little if any weight by the staff. Therefore, firms would be well-advised to document that the financial professionals' understanding of products was obtained prior to making recommendations, and documentation probably should include specialized training for new, complex, or risky products.

The staff also made clear its view that financial professionals personally need to understand each recommended product or investment strategy, rather than simply relying on the firm's review of specific investment products or strategies, or the inclusion of products on the firm's 'approved list.'

Consider Total Potential Costs

The staff recommends that firms and financial professionals "consider the total potential costs when evaluating whether the recommendation or advice is in a retail investor's best interest, including direct and indirect costs that could be borne by the retail investor." Most firms and financial professionals have considerable experience in analyzing and documenting comparisons of direct costs such as commissions, markups or markdowns, other transaction costs, and advisory or management fees.

While direct cost comparisons remain important, the bulletin suggests greater scrutiny of indirect costs, and lists certain types of fees and expenses of concern, including:

- Fees or expenses that may affect a retail investor's return such as Rule 12b-1 fees to cover the costs associated with marketing and selling shares, and possibly shareholder service costs, other administrative and service fees, and revenue sharing.
- Trading and other costs associated with dynamic investment strategies, such as the need to frequently buy and sell options or futures contracts, pay margin interest, or daily rebalance fees.
- Structural features of the investment that could magnify investor losses.
- The costs of exiting an investment or investment strategy, such as deferred sales charges or liquidation costs.
- Any relevant tax considerations.

By extrapolating products that include the types of fees and expenses referenced by the staff, it appears that staff will be looking closely at, among other things:

- Mutual fund share class selection, revenue sharing and administrative service fee arrangements.

- Trading costs associated with dynamic strategies for trading options, ETFs, or equities.
- Leveraged ETFs and ETNs that reset to their underlying benchmark on a daily basis—which magnifies returns in what is sometimes referred to as the "constant leverage trap."
- Mutual funds and other investments with high deferred sales charges; variable annuities with surrender charges; and alternative investments with significant liquidation costs.
- The tax implications of in-state versus out-of-state 529 plans, opportunity zone investments, and taxable versus tax-free fixed income investments.

Update Retail Investors' Investment Profiles Regularly

The bulletin reiterates prior guidance that "[i]n order to have a reasonable basis to believe a particular investment or investment strategy is in the best interest of a particular retail investor, you must obtain and evaluate enough information about the retail investor." The staff highlights the need to periodically update retail investors' investment profiles, and makes clear their view that this evaluation is not a "once-and-done" exercise, "particularly where the firm is aware or has reason to be aware that information in the investment profile has changed."

The staff goes so far as to assert that if updated investor information is unavailable, financial professionals "should generally decline to provide such recommendations or advice until you obtain the necessary investor information . . . [or] consider documenting the basis for your belief that such information is not relevant in light of the facts and circumstances of the particular recommendation or advice."

The staff's perspective on this point appears to minimize some of the practical challenges of dealing with a wide range of retail investors with different levels of sophistication and responsiveness. That said, to avoid being in the unfortunate position of having to consider foregoing or delaying trading pending receipt of an updated investment profile, financial professionals should calendar periodic reminders to prompt clients to update their profiles and then have administrative staff follow up as necessary.

Understand Investors' Tax Status

The bulletin highlights that because "[t]here are many investments and investment strategies where a primary feature may be a tax advantage for the investor . . . a firm and its financial professionals should consider whether the tax-advantaged option covered by their recommendation or advice is in the best interest of the retail investor based on the retail investor's investment profile."

To avoid blind spots regarding investors' tax situation, financial professionals should consider expanding information collected in putting together investment profiles and scheduling periodic updates with investors' outside tax professionals. Firms and financial professionals should pay particular attention to the tax implications of clients' investments in the following areas of concern cited by the staff:

- Out-of-state 529 college savings plans—particularly whether 529s are in the best interest of investors where their home state offers tax advantages only for investing in the home state's 529 plan.
- The tax implications of fixed income investments, including taxable, tax-free and deferred bond payments.
- Opportunity zone funds.
- Direct and custom indexing.
- Variable annuities.
- Government securities.

How to Consider Reasonably Available Alternatives

Do It Before Making Investment Recommendations

The staff devoted a large portion of the bulletin to the consideration of reasonably available alternatives, including offering views concerning appropriate processes, expectations for defining the breadth of possible alternatives, and best practices for documentation. At the outset, the staff stated that "it would be difficult for firms and their financial professionals to form a reasonable basis to believe a recommendation or advice is in the retail investor's best interest without considering alternatives that are reasonably available to achieve the investor's investment objectives."

With respect to timing, the staff recommended that "consideration of reasonably available alternatives should begin early in the process of formulating a recommendation or providing advice rather than as a retroactive exercise undertaken after the firm or financial professional has already decided what to recommend or what advice to provide."

Consideration of Reasonably Available Alternatives Should Not Be Dictated by the Firm's Platform

In implementing Reg BI, one of the most difficult decisions facing broker-dealers is how broadly to cast their net in searching for reasonably available alternatives for each investment recommendation. Determining the breadth of that search may be further complicated by the scope of each firm's platform.

Some firms have vast open architecture platforms with thousands of financial products and sponsors, while other firms may have extremely limited product offerings, which can make it much more difficult to research reasonably available alternatives. The staff acknowledges that financial professionals need not "evaluate every possible alternative available through the firm," but "still need to evaluate a range of potential alternatives sufficient to have a reasonable basis to believe a recommendation or advice is in the best interest of the retail investor."

The staff's main message regarding scope appears to be that consideration of reasonably available alternatives should be driven by investment product or strategy characteristics, rather than by the breadth of each firm's platform. In that vein, the bulletin advises that "a firm and its financial professionals cannot rely on a limited menu to justify recommending an investment or providing advice that does not satisfy the obligation to act in a retail investor's best interest."

The staff further warns that "one possible outcome of such a process is that the firm or financial professional may conclude that no investment or investment strategy they offer is in the retail investor's best interest." Unfortunately, the staff does not offer additional guidance as to scenarios when prospective clients should be turned away. But presumably, this situation will be more common for firms with more limited products and strategies, or for firms that only offer products with high risk or limited liquidity that may not be appropriate for prospective investors with low risk tolerances and/or limited investment horizons.

Document Reasonably Available Alternatives For Recommendations Involving Possible Conflicts of Interest or Inconsistencies With Investment Profiles

For the consideration of reasonably available alternatives, the staff admits that "there is no requirement of such documentation." However, the staff then arguably attempts to interpret a de facto documentation requirement in some instances by asserting that "it may be difficult for a firm to demonstrate compliance with its obligations to retail investors, or periodically assess the adequacy and effectiveness of its written policies and procedures, without documenting the basis for certain recommendations."

While this suggestion of documentation is not a requirement of Reg BI, it does provide insight on how the staff views the diligence conducted on products and best investment options for clients. In particular, the staff recommends documentation of the consideration of reasonably available alternatives "where a recommendation may seem inconsistent with a retail investor's investment objectives on its face and/or poses conflicts of interest for the firm or the financial professional."

Apply Heightened Scrutiny to Complex or Risky Products

Given the proliferation of complex and higher-risk products and their increased availability to retail investors, the SEC has repeatedly telegraphed its intention to police such recommendations pursuant to the care obligations of both investment advisers and broker-dealers. Reg BI requires heightened scrutiny as to any "potentially high-risk product" being sold to a retail investor while the bulletin expands that to all "complex" products as well.

The staff's view is that "firms and their financial professionals generally should apply 'heightened scrutiny' to whether a risky or complex product is in the retail investor's best interest." The staff then lists specific types of products "where heightened scrutiny may be necessary," including:

- Inverse or leveraged exchange-traded products.
- Investments traded on margin.
- Derivatives.
- Crypto asset securities.
- Penny stocks.
- Private placements.
- Asset-backed securities.
- Volatility-linked exchange-traded products.
- Reverse-convertible notes.

For these complex and higher-risk products, the bulletin also includes prescriptive recommendations as to what should be included in heightened scrutiny, such as:

- A "due diligence process . . . to help ensure that these products are assessed by qualified and experienced firm personnel."
- "[A]ppropriate training and supervision to help ensure financial professionals understand the features, risks, and costs of a complex financial product."
- The consideration of "whether lower risk or less complex options can achieve the same investment objectives."
- "[P]rocedures for ongoing evaluation of the complex or risky products held by retail investors to ensure that they continue to be in the investor's best interest."

Reassess Account Types Periodically

The bulletin also contains a reminder that "[d]ually registered firms and dually licensed financial professionals have an obligation to reasonably believe the recommendation or advice they provide regarding account type is in the retail investor's best interest."

Specifically, financial professionals should consider whether products or investment strategies are "better suited for the investor's brokerage account or advisory account," based upon, among other things, "reasonably expected total costs" for the investments in the account, including commissions, advisory fees and any relevant tax consequences."

Conclusion

Through Reg BI and the 2019 Fiduciary Interpretation, the SEC has emphasized its increased focus on the duty of care in the financial services industry. The SEC staff's Bulletin regarding the care obligation offers important clues how the staff will translate the Commission's interest into future examinations and enforcement actions.