

# Investment Advice Reform

## Part One: Standard of Conduct



On June 5, 2019, the U.S. Securities and Exchange Commission (“SEC”) adopted a package of rules and interpretations primarily designed to enhance the quality of principal-agent relationships (relationship where an agent [representative] is appointed to act on behalf of a principal [client or customer]) and to assist with providing full transparency to investors. The investment advice reform package encompassed the following components:

- [Newly Adopted Regulation Best Interest](#)
- [Interpretation of Investment Advisor Fiduciary Duty](#)
- [New Disclosure Requirement through a Client Relationship Summary](#)
- [“Solely Incidental Advice” Exemption for Broker-Dealers](#)

In Part One of the Investment Advice Reform white paper series we will primarily focus on the first two elements (Regulation BI and Fiduciary Duty) and how it impacts you.

### KEY TAKEAWAYS:

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- [Regulation BI does not explicitly apply to investment advisors.](#)
- [Disclosures are not always enough in demonstrating your Fiduciary Duty.](#)

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### INVESTMENT ADVICE REFORM 2

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- [Newly Adopted Regulation Best Interest](#)
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# Investment Advice Reform

## Part One: Standard of Conduct



*Understanding Standard of Conduct through the Implementation of Regulation Best Interest under the Securities Exchange Act of 1934 (“Exchange Act”) and the Interpretation of Fiduciary Duty under the Investment Advisers Act of 1940 (“Advisers Act”)*

On June 5, 2019, the U.S. Securities and Exchange Commission (“SEC”) adopted a package of rules and interpretations primarily designed to enhance the quality of principal-agent relationships (relationship where an agent [representative] is appointed to act on behalf of a principal [client or customer]) and to assist with providing full transparency to investors.

### **The investment advice reform package encompassed the following components:**

- **Newly Adopted Regulation Best Interest (“Regulation BI”)**  
A new rule enacted under the Exchange Act designed to enhance the standard of conduct for broker-dealers and their representatives when they make recommendations of any securities transactions or investment strategy involving securities to a retail customer.
- **Interpretation of Investment Advisor Fiduciary Duty (“Fiduciary Duty”)**  
An SEC interpretation of the standard of conduct as imposed under the Advisers Act in an attempt to re-emphasize the significance of an investment advisor’s fiduciary duty (duty of care and duty of loyalty) owed to clients.
- **New Disclosure Requirement through a Client Relationship Summary (“Form CRS”)**  
An SEC interpretation of the standard of conduct as imposed under the Advisers Act in an attempt to re-emphasize the significance of an investment advisor’s fiduciary duty (duty of care and duty of loyalty) owed to clients.
- **“Solely Incidental Advice” Exemption for Broker-Dealers**  
An interpretation of the “solely incidental” language under the Advisers Act that exempts broker-dealers from the definition of “investment adviser” and thus the fiduciary duty requirements of the Advisers Act.

**We will primarily focus on the first two elements (Regulation BI and Fiduciary Duty) of the four-part package.**

# Investment Advice Reform

## Part One: Standard of Conduct



It's crucial to understand that the standards required of broker-dealers and investment advisers have always been different. In general, broker-dealers earn commissions for specific periodic recommendations and transactions whereas investment advisers earn ongoing advisory fees for the continuous, ongoing oversight and management of client relationships and accounts. Due to this distinction, it's believed that the SEC felt that the same standard of conduct could not, and should not, be applied to both broker-dealers and investment advisers. As such, Regulation BI was implemented in order to enhance the standard of conduct imposed on broker-dealers and their registered representatives.

### REGULATION BI

The SEC has defined Regulation BI as the new standard of conduct for broker-dealers, requiring them to



**(i) act in the best interest of the retail customer at the time the recommendation is made; and (ii) address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest...**

which some might say is akin to the standard of conduct owed by investment advisers.

The adoption of Regulation BI has generated a lot of uncertainty, particularly for investment advisers who are not owned by or under common control with a broker-dealer as they try to understand how Regulation BI applies to them, if at all.

#### SHORT ANSWER

Regulation BI does not explicitly apply to investment advisers.

#### LONGER ANSWER

Although Regulation BI does not explicitly apply to investment advisers, a certain level of understanding of Regulation BI is important, particularly for firms where certain investment advisor representatives are dually registered as representatives with a broker-dealer. The SEC has clearly stipulated that the standard of conduct that will apply will depend on the capacity in which the individual making the recommendation is acting at the time of the recommendation. Consequently, it's important to ensure representatives have a clear understanding of the capacity in which they are working in and apply the correct standard of conduct.

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## Part One: Standard of Conduct



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### FIDUCIARY DUTY

Investment advisors, on the other hand, have always owed a fiduciary duty to their clients. The objective of the SEC interpretation is not to create new obligations or regulations for investment advisors but rather to provide clarity and help reaffirm their standard of conduct. Advisors provide advice to clients that come in all shapes and sizes. These clients may include retail investors who have fewer investment assets and might be less knowledgeable and experienced when it comes to investing, or they may be institutional clients with substantially more resources available and a heightened sophistication towards investing. As such, satisfying an advisor's fiduciary duty will depend, in part, on the nature of the client.

## ADVISOR ADVICE TO CLIENTS COME IN ALL SHAPES AND SIZES

### THESE CLIENTS MAY INCLUDE:



#### RETAIL INVESTORS

*fewer investment assets and might be less knowledgeable and experienced when it comes to investing*



#### INSTITUTIONAL CLIENTS

*more resources available and a heightened sophistication towards investing*

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As such, satisfying an advisor's fiduciary duty will depend, in part, on the nature of the client. All things considered, one thing is for certain: under no circumstance may an advisor waive the fiduciary duty owed to clients.

Fiduciary duty is comprised of two fundamental components: duty of care and duty of loyalty. Duty of care is the obligation to provide advice in the client's best interest, and duty of loyalty is the obligation to not subordinate client interests to the advisor's own interests.



## As fiduciaries, investment advisors owe their clients a duty of care



### Act in the Clients Best Interest

An advisor should make a reasonable inquiry into the client's objectives, and have reasonable belief that the advice is in the client's best interest

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### Advice and Monitoring

Providing advice and monitoring over the course of the relationship (taking into account the nature of the client relationship as mutually agreed upon).

### Best Execution

Seeking best execution where the advisor has the responsibility to select broker-dealers to execute client trades (with the goal of maximizing value for the client under the particular circumstances occurring at the time of the transaction

In order to not subordinate client interests to its own, the duty of loyalty emphasizes the need for full and fair disclosure of material conflicts of interest so that clients can understand and decide, in an informed way, whether to consent to these conflicts. In other words, disclosures must be sufficiently specific enough for clients to make an informed decision. Determining what is full and fair may be subjective, and will vary based on the nature of the client, scope of service and the conflict itself. Disclosures at a minimum must clearly stipulate the conflict at hand, how individual clients will be impacted and whether remuneration will be received. For example, in terms of full and fair, the SEC has taken a firm stance that an advisor is prohibited from stating that a conflict “may” exist, simply to cover off on all possible conflicts. Instead, regulators expect that you specify all conflicts that actually impact the advisor and its clients. For additional examples and information from the SEC regarding adequate disclosures, please read pages 24 through 28 of the Commission’s Interpretation Regarding Standard of Conduct for Investment Advisers.

Although an affirmative acknowledgment is not required for a client to provide informed consent, advisors must have reasonable belief that clients, given their individual facts and circumstances, understand the nature and essence of the conflict. If clients cannot provide informed consent, the advisor must either eliminate or adequately mitigate (i.e., modify practices) the conflict.



## WHAT DOES THIS MEAN FOR INVESTMENT ADVISORS GOING FORWARD

### SHORT ANSWER

Disclosures are not always enough!

### LONGER ANSWER

Investment advisors should conduct a comprehensive conflict of interest review and assessment to determine whether a duty of care and duty of loyalty can be satisfied for each individual conflict. To the extent an advisor cannot completely fulfill its fiduciary duty through full and fair disclosures and/or the implementation of policies and procedures, the conflict should either be eliminated or business practices must be modified.

# Investment Advice Reform

## Part One: Standard of Conduct



### HOW CAN AdvisorAssist HELP?

**The compliance tools** within the AdvisorCloud™ encompass ongoing activity tasks, forensic testing and risk assessment modules. These compliance tools allow for optimal testing, review and documentation of the firm's compliance infrastructure, while allowing firms to break down the various components of the business (e.g. fees, services, outside activities and affiliations). Ultimately, it is these compliance tools that serve as the golden source for compliance reporting and in determining the effectiveness of the firm's current compliance infrastructure, particularly as it relates to conflicts of interests.

**Conflicts of Interest:** A major component of the compliance tools is to serve as a conflict of interest registrar. Through the use of these tools, firms are able to assess whether they are meeting their fiduciary duty obligations to their clients. Firms are prompted with conflict-related tasks and questions that are designed to determine whether the firm's current disclosures are full and fair and whether policies and procedures are adequately designed to mitigate these conflicts.

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..... WHAT'S NEXT? .....

# PART TWO: CLIENT RELATIONSHIP SUMMARY

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**Taking a quick glance** the newly implemented Form CRS is related to both Regulation BI and the Fiduciary Duty interpretation and is an attempt to provide retail investors with full transparency so that they can make informed decisions. In a subsequent release, we will break down the elements of Form CRS.

Note: Full compliance and implementation of Form CRS is required by [June 30, 2020](#).

### FOR MORE INFORMATION:

[SEC Standard of Conduct Interpretation](#)

[SEC Regulation Best Interest](#)



*AdvisorAssist is a management consulting firm focused exclusively on serving investment advisory firms. Through consultative services and outsourcing, we provide expertise, resources and actionable solutions that enable investment advisors to achieve their full potential. Our talented team of industry professionals provide actionable advice and execution to advisors to help build, grow, protect and optimize their practices. From concept through launch, we partner with advisors to assist in building world-class advisory practices. For established firms, we provide the ongoing business, strategy and risk management support that enables advisors to focus on growing their practice.*

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