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Bulletin Describes SEC Staff’s Expectations Regarding Investment Advisers’ and BrokerDealers’ Conflicts of Interest

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On August 3, 2022, the SEC staff published a bulletin in question-and-answer format reiterating the standards of conduct for broker-dealers under Regulation Best Interest and for investment advisers under the Advisers Act’s fiduciary standard and reminding firms of their obligations to act in the best interest of retail investors and not to place their own interests ahead of those of investors.

Among other things, the SEC staff emphasizes that identifying and addressing conflicts should not be merely a “check-the-box” exercise, but, instead, should entail a “robust, ongoing process that is tailored to each conflict.”

While the SEC staff’s guidance acknowledges that the specific measures to be taken or factors to be considered by a firm depend on its particular facts and circumstances, including the firm’s business model and scope of services, the bulletin includes important reminders regarding the core obligations of firms that engage retail investors and offers insight on the SEC staff’s broad view of potential sources of conflicts.

The following is a summary of key points made by the SEC staff in the bulletin.

Identifying and Monitoring for Conflicts

- Notably, the bulletin states unequivocally that all firms and financial professionals have at least some conflicts of interest with their retail investors. This unambiguous position of the SEC staff is coupled with an expansive view of potential sources of conflicts of interest, including various forms of compensation, revenue or other benefits (financial or otherwise). For example, the bulletin cites compensation based on assets gathered and/or products sold, including, but not limited to, receipt of assets under management or engagement fees, commissions, markups, payment for order flow, cash sweep programs, or other sales charges, as well as payments from third parties whether or not related to sales or distribution (for example, sub-accounting or administrative services fees paid by a fund or revenue sharing).

- The SEC staff expresses the view that firms have an ongoing monitoring obligation with respect to conflicts of interest, stating that identifying and addressing conflicts is not a “set it and forget it” exercise. The bulletin states that firms should monitor conflicts over time and assess periodically the adequacy and effectiveness of their policies and procedures.

- As to policies and procedures, the bulletin advises firms to, among other things: (1) define conflicts in a way that is relevant to the firm’s business and that enables personnel to understand and identify conflicts; (2) establish a process to identify the types of conflicts that the firm and its financial professionals may encounter and how such conflicts might impact recommendations; (3) ensure there is a process to assess the firm in light of changes— such as new lines of business, products or services or organizational developments—so that any new conflicts of interest are identified; and (4) establish training programs regarding employees’ responsibilities with identifying conflicts and bringing any to management’s attention.

- The bulletin advises firms to establish a “culture of compliance”—an environment where conflicts are taken seriously and financial professionals feel empowered and encouraged to take an active role in identifying conflicts.

Disclosing Conflicts

- Disclosures should be designed to allow investors to make a more informed decision about a recommendation, and, in the case of advisers, provide informed consent to the conflict of interest—meaning, in the SEC staff’s opinion, the disclosures should be specific to each conflict and tailored to the firm’s business and compensation structures.

- Disclosures stating that a firm “may” have a conflict when the conflict actually exists are not sufficiently specific to disclose the conflict adequately to retail investors.

- The bulletin provides a list of facts that the SEC staff believes should be disclosed, at a minimum, with respect to a conflict associated with compensation or other benefits, such as the source(s) and scale of compensation for the firm and/or financial professional.

Mitigating and Eliminating Conflicts

- Disclosure of conflicts alone does not satisfy the obligation to act in a retail investor’s best interest. In the SEC staff’s view, certain conflicts should—and, in some cases, must—be addressed through mitigation. The specific mitigation measures, however, depend on the nature and significance of the incentives provided to the firm or its financial professionals and a firm’s business model. Moreover, if conflicts cannot be effectively addressed through mitigation, firms may need to determine whether to eliminate the conflict or refrain from providing advice or recommendations that are influenced by that conflict.

- In discussing generally the circumstances when a particular conflict should be eliminated, the bulletin notes that “[f]irms also may find that there are some conflicts that they are unable to address in a way that will allow the firm or its financial professionals to provide advice or recommendations that are in the retail investor’s best interest.” As an example of such circumstances, the bulletin refers to a firm’s adoption of a compensation or incentive program

providing significant benefits or penalties based on its financial professionals’ success or failure in meeting certain benchmark, quota, or other performance metrics established by the firm—beyond those that are specifically prohibited under Reg BI. In the SEC staff’s view, “the greater the reward to the financial professional for meeting particular thresholds (or conversely, the more severe the consequences for failing to meet them), the greater is the concern whether the incentive program complies with Reg BI and the IA fiduciary standard.”

- The bulletin cautions that it would be difficult for a firm to demonstrate compliance with the applicable standard of conduct without documenting the measures it takes to mitigate conflicts of interest, including periodic assessments of the firm’s policies and procedures.

Product Menus

- Even if a firm’s recommendation or advice is limited to a menu of certain products, the SEC staff believes firms must carefully consider how their product menu choices comply with obligations to act in retail investors’ best interest.

- Firms should: (1) evaluate whether providing a limited product menu or otherwise limiting the range of products offered creates a conflict that could incentivize the firm to offer products that place the interests of the firm or its professionals ahead of retail investors' interest; (2) consider establishing product review processes for the products they offer (or that they are offered by an affiliate)--including, for example, evaluating the use of "preferred lists," identifying and mitigating the conflicts of interest associated with the product, such as payments for shelf space, or restricting the retail investors to whom certain products may be recommended; and (3) identify and disclose any material limitations placed on the recommended securities or strategies and any conflicts of interest associated therewith.

The SEC staff bulletin is available here.

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