Proskauer

SEC Staff Issues Bulletin on the Care Obligations of Advisers and Broker-Dealers to Retail Investors

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On April 20, 2023, the staff of the Securities and Exchange Commission (the "SEC") published an FAQ-style bulletin[1] that provides guidance on the care obligations of broker-dealers and investment advisers in providing investment advice and recommendations to retail investors. The bulletin emphasizes the importance of complying with the Care Obligation of Regulation Best Interest ("Reg BI") for broker-dealers and the duty of care enforced under the Investment Advisers Act of 1940, as amended (the "IA fiduciary standard") for investment advisers (together, the "care obligations"). The care obligations are drawn from key fiduciary principles, including an obligation to act in the retail investor's best interest and not to place the fiduciary's interests ahead of the investor's interest.

The care obligations generally include the following three components:

- understanding the potential risks, rewards, and costs associated with an investment or investment strategy,
- having a reasonable understanding of the specific retail investor's investment profile, and
- having a reasonable basis to conclude that the recommendation or advice provided is in the retail investor's best interest.

The evaluation of whether a recommendation or advice satisfies the care obligations is an objective evaluation based 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.

The bulletin is intended to assist firms and their financial professionals in meeting their care obligations to provide advice and recommendations in the best interest of retail investors. The bulletin should be read in conjunction with other relevant sources, including Reg BI and the specific SEC releases discussing Reg BI[2] and the IA fiduciary standard[3].

While the bulletin focuses primarily on advisers and broker-dealers interacting with retail investors, many of the points of focus highlighted in the bulletin, including an emphasis on evaluation of the costs of certain products and the need for "heightened scrutiny" of more risky or complex structures, appear focused on alternative investment products, including non-traded business development companies ("BDCs") and registered tender offer and interval fund products that have increased in popularity over the past several years. As a result, the bulletin and the staff views that it describes also likely will impact the marketing of alternative investment regulated fund products to high-net-worth investors through traditional financial adviser and broker-dealer channels.

I. Understanding the Investment or Investment Strategy

Under the care obligations, investment advisers, broker-dealers, and their financial professionals need to understand the investments and investment strategies on which they advise or which they recommend to retail investors. To have a reasonable basis to believe that their advice or recommendation is in the retail investor's best interest, they must develop a sufficient understanding of the potential risks, rewards, and costs of the investment or investment strategy.

The non-exhaustive list of factors that firms and financial professionals need to consider to develop such an understanding of an investment or investment strategy include:

- its objectives,
- costs (including direct and indirect costs),
- key characteristics and risks,
- likely performance in different market and economic conditions,
- expected returns,
- expected payout rates,
- potential losses,

- any special or unusual features, and
- its role within the context of the investor's actual or anticipated investment portfolio.

Where there is an ongoing monitoring obligation, the reasonable investigation also requires continued analysis after the purchase of the investment and over the course of the relationship.

While costs should not be the only consideration, firms and financial professionals must always consider costs as a factor when providing advice or recommending an investment to a retail investor. The total potential costs should be evaluated, including direct and indirect costs, commissions, markups or markdowns, sales loads or charges, advisory or management fees, other fees or expenses that may affect a retail investor's return, and the trading and other costs associated with an investment strategy. In the staff's view, an analysis of costs should include costs beyond the explicit costs disclosed on a trade confirmation or account statement. Accordingly, certain alternative investment products, including non-traded BDCs and registered tender offer and interval funds, may face greater scrutiny as a result of their typically higher fees and expenses when compared to mutual funds or exchange-traded products.

Firms should provide financial professionals with sufficient information and training to understand the investments and investment strategies they recommend. While care obligations apply at both a firm and individual level, financial professionals cannot solely rely on the efforts of others at their firm to satisfy their own care obligations and must personally understand the investment or investment strategy.

II. Understanding the Retail Investor's Investment Profile

The bulletin discusses the importance of understanding an investor's "investment profile" to satisfy care obligations. An investment profile refers to information about the retail investor, which a financial professional should make reasonable efforts to ascertain. To establish a reasonable understanding of the investor's profile, information such as their financial situation, investments, assets and debts, tax status, age, investment time horizon, risk tolerance, and financial goals should be considered. The information is not exhaustive, and additional or different factors may be considered.

Broker-dealers and advisers must have sufficient information to make recommendations or provide advice, and the profile may need to be updated regularly to comply with their respective obligations. If the investor's information is unavailable, broker-dealers and advisers should carefully consider whether they have a sufficient understanding of the investor to provide recommendations or advice. The tax status of the investor or account is also an important consideration when selecting or providing advice on a particular investment or investment strategy relative to other options.

III. Considering Reasonably Available Alternatives

The bulletin suggests that investment advisers, like broker-dealers, should consider reasonably available alternatives when providing investment advice to retail investors. In the staff's view, what constitutes a reasonable consideration of available alternatives will ultimately depend on a particular investor's profile and the nature and circumstances of the firm (including a firm's use of open architecture frameworks and limited investment menus). A reasonable recommendation process should include guidelines for the firm's financial professionals that define the scope of alternatives that should be considered and the factors that should be weighed. Moreover, the process of considering available alternatives should start early when formulating a recommendation, rather than being a retrospective exercise.

The staff also notes that, although there is no requirement for firms to document the evaluation of reasonably available alternatives, "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." The staff emphasized that such documentation may be particularly important where a recommendation seems to conflict with an investor's investment objectives or poses conflicts of interest for the firm or financial professional.

IV. Special Considerations: Complex or Risky Products

Firms and financial professionals should apply “heightened scrutiny” when considering whether a complex or risky product is in a retail investor’s best interest. Examples of risky or complex products include 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, and reverse-convertible notes. The staff recommends that firms establish procedures specifically designed to address recommendations, or advice about, complex or risky products. This includes due diligence processes, appropriate training and supervision, evaluating reasonably available alternatives (including lower risk or less complex options), and documenting the process and reasoning behind the particular recommendation or advice. While many alternative investment products in the registered fund space may fall outside the scope of what the staff considers “complex” or “risky,” the lack of clear bright lines for when “heightened scrutiny” would apply could cause some uncertainty with respect to its applicability to regulated fund products such as non-traded BDCs or other non-traded registered fund products that may use significant leverage or derivatives as a material portion of their investment process.

V. Special Considerations: Recommendations and Advice by Dual Registrants

Whether Reg BI or the IA fiduciary standard applies to a dually registered firm and/or financial professional depends on a facts and circumstances analysis, including factors such as the type of account, how the account is described, the type of compensation, and the extent to which the firm or financial professional disclosed to the customer or client the capacity in which they were acting. The staff caveats that the disclosure of capacity may not be determinative if the facts and circumstances suggest the financial professional was acting in a different capacity from the one disclosed. Ultimately, both the Reg BI and the IA fiduciary standard yield similar results in terms of the responsibilities owed to retail investors.

Dually registered firms and dually licensed financial professionals have an obligation to consider whether an investment or investment strategy is more appropriate for a retail investor's brokerage account or advisory account when providing recommendations or advice. 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 account-level costs such as commissions, advisory fees on assets under management, or tax consequences over the expected life of the investment. The financial professional should have a reasonable basis to believe that the recommendation or advice is in the best interest of the retail investor and not based on materially inaccurate or incomplete information.

Key Takeaways

While the bulletin and similar guidance are not "a rule, regulation or statement" of the SEC and have "no legal force and effect," broker-dealers and investment advisers should consider the guidance in light of the SEC's increased focus on care obligations. The SEC's 2023 exam priorities advised that the SEC will continue to prioritize examinations of broker-dealers and investment advisers to ensure that retail investors are receiving recommendations in their best interests. In this regard, the SEC notes that broker-dealers and dually-registered investment advisers are an area of continued interest, as are affiliated firms with financial professionals that service both brokerage customers and advisory clients. Broker-dealers and investment advisers would be well-served to take note of staff recommendations in the bulletin, particularly with respect to implementing and documenting appropriate processes for advising retail investors. Additionally, when adopting and implementing reasonably designed policies and procedures regarding their care obligations, broker-dealers and investment advisers should tailor those policies and procedures, taking into consideration their particular business models and relationships with retail investors.

Separately, sponsors of existing or proposed alternative investment regulated fund products, including non-traded BDCs and registered tender offer and interval funds, should consider whether their investment strategy and structure may cause their regulated fund products to be viewed as “complex” or “risky,” and therefore subject to heightened scrutiny. Similarly, such sponsors may wish to consider updating offering documents and other marketing materials to address potential concerns regarding the aggregate fees and expenses of such alternative investment regulated fund products, along with the other key factors highlighted by the staff in the bulletin. In particular, while the bulletin could lead to greater scrutiny of certain non-traded BDCs and registered tender offer and interval fund products by both advisers and broker-dealers seeking to invest client assets, it also may provide an opportunity for certain sponsors to differentiate their alternative investment products to those retail advisers and broker-dealers by addressing the points discussed in the bulletin.

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[1] Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations (Apr. 20, 2023), available at SEC.gov | Staff Bulletin [1]: Standards of Conduct for Broker-Dealers and Investment AdvisersCare Obligations.

[2] Exchange Act rule 15*l*-1; Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031, 84 FR 33318, 33320-21 (June 5, 2019).

[3] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 84 FR 33669, 33669 n.7, 33672 (June 5, 2019).