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Legal Update

SEC Issues Staff Bulletin Clarifying Care Obligations of Broker-Dealers

Staff Discusses Special Considerations regarding Complex or Risky Products

On April 20, 2023, the staff (the "Staff") of the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") issued a staff bulletin (the "Bulletin"), reiterating the standards of conduct for broker-dealers (as well as investment advisers) in addressing their obligations in providing investment advice and recommendations to retail investors.[1] The Bulletin focused on the care obligation under Regulation Best Interest ("Reg BI") under the Securities Exchange Act of 1934 applicable to broker-dealers (the "Reg BI Care Obligation" or "care obligations") and the duty of care under the Investment Advisers Act of 1940. The Staff expressed the view that although the specific application of the care obligations may differ between them and be triggered at different times, the two standards generally result in the same responsibilities being owed to retail investors.

The Bulletin provided 20 questions-and-answers 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 questions-and-answers address three overarching and intersecting components of the care obligation, divided as follows:

1. Understanding the potential risks, rewards and costs associated with an investment or investment strategy to be recommended to a retail investor;
2. Understanding the investment profile of the specific retail investor; and
3. Based on the recommender's understanding of the first two elements, and considering reasonably available alternatives, having a reasonable basis to conclude that the recommendation or advice provided is in the retail investor's best interest.

Of note, the Staff also provided questions and answers identifying special considerations in two areas: (i) advice/recommendations regarding complex or risky products and (ii) advice/recommendations by "dual registrants" registered as both broker-dealers and investment advisers. This Legal Update will summarize the guidance provided by the Staff for broker-dealer with a focus on complex products.

Understanding the Investment or Investment Strategy

The care obligations require broker-dealers and their financial professionals to understand the investments and investment strategies before making a recommendation. The Staff stated that, without this understanding, firms and their financial professionals cannot have a reasonable basis to believe that their recommendation or advice aligns with a retail investor's investment profile in a way that satisfies their care obligations.

The Bulletin provided a non-exhaustive list of factors that the Staff considers relevant in evaluating the risks, rewards and costs of an investment or investment strategy:

- The objectives of the investment or investment strategy (such as whether it is designed to provide income, principal protection, growth, or exposure to a specific market sector, or is designed to be held for a long or short term);
- The initial and ongoing costs of the investment or investment strategy (such as direct and indirect costs, as well as potential costs, such as redemption fees);
- The investment or investment strategy's key characteristics and risks (such as liquidity or volatility), or other features that may impact the investment (e.g., margin call terms or early repayment of debt underlying a securitized product);
- The investment or investment strategy's likely performance in a variety of market and economic conditions;
- The expected returns, expected payout rates, and potential losses of the investment or investment strategy;
- Any special or unusual features of the investment or investment strategy (such as tax advantages or guaranteed payments); and
- The role of the investment or investment strategy within the context of the retail investor's actual or anticipated investment portfolio.

The Bulletin also stated that costs are always a relevant factor when recommending or providing advice on investments or investment strategies. The Staff, however, clarified that costs should not be the only consideration, and care obligations cannot be satisfied solely by recommending the lowest cost option. When evaluating whether the recommendation or advice is in a retail investor's best interest, total potential costs, including direct and indirect costs that could be borne by the retail investor, should be considered.

Further, the Bulletin emphasized that financial professionals cannot rely solely on their firm's review to satisfy their personal obligation to understand an investment or investment strategy being recommended or advised on. As a result, financial professionals remain personally responsible for understanding an investment or investment strategy before they recommend or provide advice with regard to that investment or investment strategy.

Understanding the Retail Investor's Investment Profile

The Staff defined an "investment profile" as "information that the firm or financial professional generally should make reasonable efforts to ascertain about the retail investor." The Staff considered that obtaining and evaluating information about the retail investor's investment profile is a critical step to satisfying the care obligation in order to have a reasonable basis to believe that a particular investment or investment strategy is in the best interest of a particular retail investor. The reasonableness of efforts to collect information needed about a retail investor's investment profile depends on the specific facts and circumstances. The Staff considered that the firm or financial professional must also have a reasonable basis to believe that such recommendation or advice is not based on materially inaccurate, incomplete or outdated information about the retail investor.

As part of establishing a reasonable understanding of the retail investor's investment profile, the Staff believes that the following information should be obtained, without limitation:

- The investor's financial situation (including current income) and needs;
- The investor's investments, assets and debts;
- The investor's marital status, tax status and age;
- The investor's investment time horizon, liquidity needs, risk tolerance, investment experience, investment objective and financial goals; and
- Any other information the retail investor may disclose to a firm or financial professional in connection with the recommendation or advice.

This list of factors is non-exhaustive. A firm or financial professional may, and in some cases may need to, consider additional or different factors as appropriate under the specific facts and circumstances.

The Staff further clarified that gathering information for the retail investor's investment profile is not a "once-and-done exercise" but that the investment profile should be continually updated in order for a broker-dealer to have "sufficient information" to make a recommendation or provide advice in a retail investor's best interest. Broker-dealers may need to update the investor's investment profile to comply with their respective obligations.[2] Further, in cases where investor information is unavailable despite reasonable diligence to obtain it, a broker-dealer should carefully consider whether there is sufficient understanding of the retail investor to evaluate if any recommendation or advice is in that retail investor's best interest.

The Staff also clarified what it means to consider an investor's tax status when providing recommendations or advice. When a retail investor or financial professional identifies a goal with tax implications or seeks to obtain a particular tax advantage as an investment objective, a firm and its financial professionals should consider whether the tax-advantaged option is in the best interest of the retail investor. Tax status may be an important consideration when selecting or providing advice on a particular investment or investment strategy relative to other options. However, the existence of a tax advantage would not, by itself, give rise to a reasonable belief that a recommendation is in the retail investor's best interest. The Staff believes a factor such as tax advantage should be considered in light of the other features of the investment or investment strategies, reasonably available alternatives, and the retail investor's entire investment profile, including if a retail investor already has one or more tax advantaged investments.

Considering Reasonably Available Alternatives

The Staff stated that broker-dealers should consider reasonably available alternatives when recommending or providing advice about investments or investment strategies to retail investors. In the Staff's view, reasonably available alternatives should be considered early in the process of formulating a recommendation or providing advice, instead of a retroactive exercise undertaken after the firm or financial professional has already decided what to recommend or what advice to provide. The Staff believes that such consideration should involve comparing reasonably available alternatives in light of a particular retail investor's investment profile.

The Staff also stated that firms should have a reasonable process for identifying the scope of reasonably available alternatives that their financial professionals should consider. Although specific steps may vary, the Staff believes the process of developing an investment recommendation or advice should begin by considering a broader array of investments or investments strategies that are generally consistent with the retail investor's investment profile, and then narrowing these to a smaller range of potential investment options.

Once reasonably available alternatives have been identified that are consistent with the retail investor's investment profile, firms should have a reasonable process for evaluating the alternatives. The process should be tailored to the firm's particular business model and investment offerings, and should include guidance including, for example, policies and procedures or employee training for the firm's financial professionals that defines the scope of alternatives that should be considered and the factors that should be weighed in evaluating the available alternatives.

The Staff recognized that certain firms may have an extensive range of investment offerings that makes it difficult for financial professionals to be familiar with every investment available to investors. In such cases, a financial professional does not have to evaluate every possible alternative available through the firm, provided that financial professionals would still need to evaluate a reasonable range of potential alternatives. On the other hand, other firms may have a limited menu of investments. In such cases, the staff's view is that a financial professional associated with a firm that has only a limited menu of investments generally should be familiar with each of those investments that are available to investors.

As to unique financial products, the Staff also recognized that innovation has resulted in the development of complex products with highly particular features that make them unique. Such products may be too unique to have strictly identical alternatives. However, the Staff believes that products that are not identical may still be comparable to each other for purposes of identifying reasonably available alternatives based on the retail investor's investment profile, among other factors.

Finally, although the Staff stated that there is no requirement to document the evaluation of reasonably available alternatives, the Staff stated that it may be difficult for a firm to demonstrate compliance with its obligations or to periodically assess the adequacy and effectiveness of its policies and procedures if the basis for certain recommendations was not documented.[3]

Special Considerations for Complex or Risky Products

The Staff also provided special considerations for complex or risky products. In the view of the Staff, Reg BI does not prohibit a financial professional from recommending or providing advice on complex or risky products, as long as the financial professional has established a reasonable basis to believe that such a product is in the best interest of the retail investor, considering the retail investor's particular investment profile.

However, in the Staff's view, complex or risky products may not be in the best interest of a client in the absence of an identified, short-term, customer-specific trading objective. The Staff expressed the view that firms and financial professionals should consider whether less complex, less risky or lower cost alternatives can achieve the same objectives for their retail customers as part of their overall reasonable-basis analysis.

Moreover, the Staff stated that firms and their financial professionals generally should apply "heightened scrutiny" to determine whether a risky or complex product is in the retail investor's best interest. The Staff clarified that "heightened scrutiny" means that firms and their financial professionals should take steps to understand the more complex or additional risk features about a certain product, including understanding of the terms, features, and risks of those products. The Staff's examples of products where heightened scrutiny may be necessary include, but are not limited to, 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 also clarified that under "heightened scrutiny," firms and their financial professionals should obtain information about the retail investor that supports a conclusion that a complex or risky product is in that retail investor's best interest. Depending on the product in question, such information might include, for example, whether the retail investor has an identified, investor-specific trading objective that is consistent with the product's description in its prospectus or offering documents, or has the ability to withstand heightened risk of financial loss. However, the fact that an investor has such an objective or ability does not *automatically* mean that the product is in the retail investor's best interest.

Practical Considerations

Firms that recommend or advise on complex or risky products to retail investors should strongly consider establishing procedures specifically designed to address recommendations or advice on such products. For example, the Staff recommended that firms could consider developing procedures outlining the due diligence process for such products, to help ensure that these products are assessed by qualified and experienced personnel.

Firms should also consider establishing appropriate training and supervision procedures to help ensure financial professionals understand the features, risks and costs of a complex product. Additionally, firms should consider establishing procedures for evaluating reasonably available alternatives to complex or risky products they recommend or provide advice about. In the Staff's view, firms that recommend or advise on complex or risky products to retail investors should also consider documenting the reasoning and process behind developing particular recommendation or advice, including consideration of less complex alternatives, and how the product fits within the retail investor's broader goals or strategy. Finally, for circumstances where the firm or financial professional has an obligation to monitor investor accounts, the Staff believes that the firm should consider establishing procedures 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.

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Endnotes

[1] See Securities and Exchange Commission, *Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations*, (April 20, 2023), available at https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers. The term "retail investor" for these purposes means any person who qualifies as a "retail customer" as defined in SEC Rule 15l-1(b)(1), or a natural person client of an investment adviser.

[2] Broker-dealers should generally make a reasonable effort to ascertain information regarding an existing retail investor's investment profile prior to the making of a recommendation, on an "as needed" basis when such broker-dealer knows or has reason to believe that the customer's investment profile has changed. A broker-dealer must periodically attempt to update customer account information consistent with existing Exchange Act books and records requirements. *See* Exchange Act rule 17a-3(a)(17); *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Exchange Act Release No. 86031, 84 FR at 33398 (June 5, 2019). Similarly, investment advisers must generally update the client's investment profile in order to maintain an understanding of the client's objectives and adjust the advice to reflect any changed circumstances. *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act of 1940, Release No. 5248, 84 FR 33673 (June 5, 2019). The frequency with which such updates should occur turns on facts and circumstances.

[3] The Staff had previously issued a Risk Alert containing examples of policies and procedures that may contain deficiencies or weaknesses in complying with the care obligation under Reg BI. See Securities and Exchange Commission, *Observations from Broker-Dealer Examinations Related to Regulation Best Interest* (January 30, 2023), available at https://www.sec.gov/file/exams-reg-bi-alert-13023.pdf.