

SEC Staff Bulletin Provides Detailed Guidance for Broker-Dealers and Investment Advisers on the Care Obligations to Retail Investors

May 3, 2023

On April 20, 2023, the U.S. Securities and Exchange Commission (“SEC”) published an updated [staff bulletin](#) (“Bulletin”) regarding the standards of conduct for broker-dealers and registered investment advisers in their interactions with retail investors. The bulletin focuses chiefly on the Care Obligation of [Regulation Best Interest](#) (“Reg BI”) for broker-dealers and the [duty of care](#) applicable under the Investment Advisers Act of 1940 (the “IA fiduciary standard”). The Bulletin refers to these duties as “care obligations,” which, while differing in certain respects, “yield substantially similar results in terms of ultimate responsibilities owed to retail investors.”

The Bulletin primarily addresses three “overarching and intersecting” components of the care obligations:

- Understanding the possible risks, rewards, and costs of products, investment strategies, account types, or series of transactions;
- Having a reasonable understanding of the specific retail investor’s investment profile, which generally includes many categories of financial and personal information; and
- The consideration of reasonably available alternatives, which, in combination with the first two elements, should form a reasonable basis to conclude that the recommendation or advice provided is in the retail investor’s best interest.

The Bulletin offers guidance on each of these aforementioned components in question-and-answer format with the aim of assisting firms and financial professionals with meeting their care obligations and, in turn, complying with their obligations to provide advice and recommendations in the best interest of retail clients and customers. The staff notes that the Bulletin should be read in tandem with Reg BI and Commission releases discussing Reg BI and the IA fiduciary standard.

The issuance of the Bulletin sends a message that the Commission continues to prioritize the protection of retail investors, and will continue to scrutinize investment

recommendations and advice to retail investors. Consistent with the [Division of Examinations' 2023 Priorities](#) (which identify Reg BI and the IA fiduciary standard as one of four “notable new and significant focus areas”), the Bulletin also signals that alleged violations of the care obligation will likely be the basis of future examinations and Enforcement matters. Moreover, given recent SEC litigation in which defendants asserted that they lacked fair notice of Reg BI’s obligations,¹ the Bulletin will serve to remind registrants of their care obligations under Reg BI and the IA fiduciary standard. Furthermore, while Reg BI and the IA fiduciary standard remain distinct obligations, the Bulletin suggests equivalence between the care obligations under both standards, and that more generally the Commission will seek to highlight potential areas of convergence across the two. Takeaways from each theme are below:

Understanding the Investment or Investment Strategy

- Before advising on or recommending an investment or investment strategy to a retail investor, broker-dealers, investment advisers, and their financial professionals need to sufficiently understand the potential risks, rewards, and costs of an investment or investment strategy to have a reasonable basis to conclude that the recommendation or advice is in the retail investor’s best interest.
- Factors that firms and financial professionals may consider to develop such an understanding of the investment or investment strategy include, but are not limited to: the objectives and initial costs of an investment or investment strategy; its key characteristics, ongoing costs, risks, and likely market performance; its expected returns, payout rates, and potential losses; the characteristics of any of its unusual features; and its role in the context of the retail investor’s actual or anticipated investment portfolio.
- Where a broker-dealer or investment adviser has “an ongoing monitoring obligation,” reasonable investigations “will require continued analysis after purchase of the investment and over the course of the relationship.”
- Costs, in particular, are “always” a relevant factor when providing a recommendation or advice to retail investors on investments or investment strategies. Such an analysis should focus on “total potential costs,” “including direct and indirect costs” for the investor. In short, “an analysis of costs, in the staff’s view, should include

¹ SEC v. W. Int’l Sec., Inc., No. 2:22-cv-04119-ODW, 2023 WL 2480732, at *5 (C.D. Cal. Mar. 13, 2023).

costs beyond the explicit costs disclosed on a trade confirmation or account statement.”

- While firms have duties under their care obligations, financial professionals are also responsible for understanding an investment or investment strategy before they recommend it or provide advice regarding it.

Understanding the Retail Investor's Profile

- Gathering and evaluating the information to create a retail investor's profile is “a critical step” to satisfying a firm's and financial professional's care obligations. A reasonable effort to collect and evaluate this information depends on specific facts and circumstances involving the retail investor and proposed recommendation or advice, but firms and financial professionals should always have a reasonable basis to believe that their advice is not based on materially inaccurate, incomplete, or outdated information about the retail investor.
- Specific categories of information to consider for the retail investor's profile include, but are not limited to, the investor's financial situation and needs; current investments, assets, and debts; marital status, age, tax status, liquidity needs, risk tolerance, and investment experience; investment time horizon and goals; and any other information a retail investor may disclose in connection with the recommendation or advice. Investment profile information should be updated when a firm becomes aware of changes or inconsistencies.
- If investor information is unavailable despite reasonable diligence to obtain it, firms must carefully consider whether they have sufficient understanding to form a reasonable basis that any recommendation or advice is in the retail investor's best interest. In cases without sufficient information about the retail investor, the staff directs firms and financial professionals to “generally decline to provide such recommendations or advice until [they] obtain the necessary investor information.” The staff advises firms or financial professionals that decide not to obtain or evaluate information that normally would be contained in an investment profile to document their justification for why such information is not relevant in the context of a particular recommendation or advice.

Considering Reasonably Available Alternatives

- Consideration of reasonably available alternatives is “inherent” to the satisfaction of care obligations. The Bulletin states that the 2019 Commission Interpretation Regarding Standard of Conduct for Investment Advisers (“Fiduciary Interpretation”)² establishes that advisers have a duty to act in the best interest of the client that cannot be satisfied through disclosure alone, and observes that the Commission has brought enforcement actions against investment advisers for failing to consider certain available alternatives when selecting or recommending investments for their clients.
- Firms and financial professionals should be proactive in considering reasonably available alternatives, evaluating them early in the process of formulating recommendations and advice. Relatedly, firms should implement “a reasonable process for establishing and understanding the scope of such reasonably available alternatives.” For example, the analysis should begin by identifying the investments or investment strategies that can generally be made available to retail investors; the scope of such alternatives “should be narrowed further in light of the particular retail investor’s investment profile.” Risks, rewards, and costs of reasonably available alternatives must be considered.
- Once firms identify reasonably available alternatives consistent with the retail investor’s investment profile, the firms should have a reasonable process for evaluating those alternatives. The process should include guidance regarding the scope of alternatives to be considered and the factors that should be weighed in evaluating them. The alternatives a firm considers may depend on whether the firm offers a limited menu of products or, conversely, has an “open-architecture” framework. The staff notes that products that are not identical may still be sufficiently comparable to serve as reasonable alternative investments depending on the retail investor’s investment profile.
- After assessing reasonably available alternatives, a firm may decide that no investment or investment strategy it offers is in the retail investor’s best interest, even where one product is the best of those available. In that situation, the staff cautions that if a firm were nonetheless to recommend or advise that investment or investment strategy to the retail investor, it would likely not satisfy the care obligations.

² See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 84 Fed. Reg. 33669, 33669 n.7, 33672 (June 5, 2019).

- While the care obligations do not require firms to document the evaluation of reasonably available alternatives, the staff notes that it might be difficult to demonstrate compliance with the obligations in the absence of such documentation.

Special Considerations for Complex or Risky Products

- Neither Reg BI nor the IA fiduciary standard prohibits recommendations of or advice about complex or risky products to retail investors where there is a reasonable basis to believe that such a product would be in the retail investor's best interest. But to satisfy their care obligations in this context, firms and financial professionals should determine "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" and apply "heightened scrutiny" to complex or risky products. Examples of complex or risky products that the Bulletin states might warrant heightened scrutiny 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.
- "Heightened scrutiny" involves obtaining information about the retail investor that would support a conclusion that a complex or risky product is in that investor's best interest, including assessing whether the retail investor has an investment-specific objective or has a heightened ability to withstand the risk of loss. However, even if the retail investor has such an objective, firms and their financial professionals must still have a reasonable basis to believe that the investment is in the retail investor's best interest and assess the relevant reasonably available alternatives.
- The Bulletin strongly encourages firms to have written policies and procedures designed to address recommendations and advice regarding complex or risky products.

Special Considerations for Recommendations and Advice by Dual Registrants

- Determining whether Reg BI or the IA fiduciary standard applies to a particular recommendation or advice provided by a dually registered firm or financial professional is a fact-specific inquiry. "The Commission considers, among other factors, the type of account, how the account is described, the type of compensation, and the extent to which the dually registered firm and financial professional made clear to the customer or client the capacity in which they were acting."

- In this regard, both Reg BI and the IA fiduciary standard require firms or financial professionals to disclose to the retail investor the capacity in which they are acting, namely, as a broker-dealer or as an investment adviser.
- Dual registrants must consider whether a brokerage or advisory account is more appropriate for an investment or investment strategy when providing recommendations or advising retail investors.
- Further, “where a retail investor holds both brokerage and advisory accounts, the staff believes a dually registered firm or dually licensed financial professional should consider whether a recommendation of an investment or investment strategy is better suited for the investor’s brokerage account or advisory account.” This process should consider the “reasonably expected total costs depending on whether the investment or investment strategy is held in the retail investor’s brokerage or advisory account,” and including but not limited to advisory fees, commissions, and tax consequences over the life of the investment.

Takeaways

- The Bulletin underscores the Commission’s continued commitment to retail investor protection. The Bulletin provides additional guidance to put registrants on further notice of the duty of care with respect to retail investors, and likely foreshadows increased Reg BI examination and enforcement activity.
- Firms should evaluate their policies and procedures to ensure compliance with the specific recommendations in the Bulletin involving (for example) investment profiles; the consideration of investment alternatives; documentation; and complex and risky products (which the Bulletin defines in specificity with several examples). The particularized guidance for policies and procedures may signal that EXAMS may move from verifying the existence of broadly relevant policies and procedures to probing firms’ policies and procedures more substantively than in the past. Such increased scrutiny would be consistent with the identification of Reg BI and the fiduciary duty of investment advisers as priority areas in the 2023 EXAMS Priorities.
- The Bulletin arguably also creates increased scrutiny for recommendations or advice involving complex or risky products. Firms and financial professionals may have challenges in meeting this seemingly heightened standard for certain types of investors, underscoring the importance of documentation in this area.

- The Bulletin's focus on cost is consistent with the Commission's prior initiatives such as the [Share Class Selection Disclosure Initiative](#) and enforcement matters related to revenue sharing, and suggests that Examinations and Enforcement will continue to scrutinize investment costs borne by retail investors.

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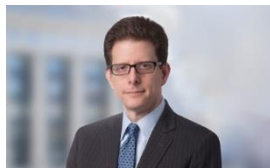


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