Article from
Risks & Rewards
August 2019
Issue 75

The Emerging Patchwork of Investment Advice Regulation

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Financial institutions are subject to various laws and regulations designed to provide protection to their customers. For financial institutions engaged in the business of providing investment advice or recommending securities or insurance products, the laws and regulations governing customer protection may be issued by one of many regulatory bodies, including the U.S. Securities and Exchange Commission (SEC), the U.S. Department of Labor (DOL), the Financial Industry Regulatory Authority, state securities regulators and state insurance regulators. For actuaries who work alongside financial institutions under the watch of these regulators, this article seeks to provide a glimpse into recent changes to various standards of care owed to customers that will undoubtedly have a significant impact on the products and services offered by many financial institutions. First, we provide a quick look at the current regulatory landscape:

- SEC-registered (or federal) investment advisers owe a fiduciary duty to their clients, which means that investment advisers have an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to their clients as well as a duty to avoid misleading them. This standard, outlined in more detail later, aligns with state standards of care governing state-registered investment advisers.

- Fiduciaries under employee retirement plans owe duties of loyalty, prudence and diversification and must refrain from engaging in transactions with "parties in interest," acting with a self-interest or conflicted interest, and receiving payments from third parties.

- Broker-dealers must act in the best interests of their customers and refrain from placing broker-dealers' interests ahead of customers' interests.

- While state laws and rules applicable to insurers and insurance producers vary, many states have adopted some form of a suitability rule that requires insurance producers (or insurers where no producer is involved) to have reasonable grounds for believing that, among other things, a recommendation is suitable for a customer based on the facts disclosed by the customer as to his or her investments or other insurance and his or her financial situation and needs, including information such as the customer's age, income, financial objectives, time horizon, liquidity needs, risk tolerance, etc.

On June 5, 2019, the SEC adopted its Regulation Best Interest (Regulation BI), creating the best interest standard of care described earlier for broker-dealers. In the months to come, we will likely see reactions to Regulation BI and the advancement of a number of laws and regulations related to investment advice and recommendations by state legislatures and state securities regulators. Any new state laws and regulations will add to the existing regulatory landscape in this area, which now includes the SEC's and states' longstanding fiduciary duties for investment advisers, the SEC's new Regulation BI, the DOL's longstanding fiduciary standard under the Employee Retirement Income Security Act of 1974 (ERISA) and New York's recently adopted regulation governing insurance producers. So far, New Jersey and Nevada (the latter not outlined in Table 1) have proposed new standards of care governing both broker-dealers and investment advisers, and additional states are expected to follow suit. Firms subject to state laws and regulations will face compliance challenges, including the possibility that state laws and regulations may conflict with one another. Moreover, these new obligations could result in limits on the availability of advice or certain products and will surely lead to increased costs for financial institutions. Table 1 is intended to provide a glimpse into the emerging framework that has already started to shape the activities of firms in the securities and insurance space and, as a result, will influence the work of the actuarial professionals who work alongside these firms.

Table 1
Emerging Investment Advice Framework

	SEC- and State-Registered Investment Advisers	SEC-Registered Broker-Dealers (Under SEC Regulation Best Interest)	Proposed New Jersey Securities Regulation	ERISA Fiduciaries Subject to DOL Rules	Producers and Insurers Subject to New York Regulation 187
What is the duty owed to customers and clients?	Investment advisers are fiduciaries; they owe a duty of care and a duty of loyalty, and they must act in the best interests of clients and cannot place their own interests ahead of the interests of their clients.	Broker-dealers must act in the best interests of their retail customers at the time recommendations are made, without placing the financial or other interests of the broker-dealer ahead of the customers' interests.	Broker-dealers and investment advisers owe a fiduciary duty to customers, which requires them to satisfy both the duty of care and the duty of loyalty.	ERISA fiduciaries are subject to duties of loyalty, prudence and diversification; also prohibitions on transactions with "parties in interest" (which includes a broker-dealer) on acting with a self-interest or conflicted interest and on receiving payments from third parties.	A producer (or insurer where no producer is involved) must act in the best interests of the consumer, and only the interests of the consumer shall be considered in making recommendations.
When is the duty triggered?	Establishing an advisor-client relationship.	Making recommendations of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer.	When providing investment advice or recommending to a customer an investment strategy; the opening of any type of account; the transfer of assets to any type of account; or the purchase, sale or exchange of any security. Also, when providing investment advice and when acting: (i) with discretionary authority over a customer's account; (ii) with a contractual fiduciary duty; or (iii) as an adviser.	When providing investment advice for a fee to an ERISA plan or participants, or exercising discretion in the investment of ERISA plan assets within the meaning of ERISA.	When making recommendations to consumers for a sales transaction or an in-force transaction with respect to life insurance or annuity policies delivered or issued for delivery in the state of New York.
Who is covered?	Investment advisers subject to the Advisers Act or corresponding state laws as well as supervised persons of such investment advisers.	Broker-dealers, as well as any persons associated with the broker-dealer (i.e., registered representatives and principals), when making recommendations of a securities transaction or investment strategy involving securities (including account recommendations) to retail customers.	All SEC-registered broker-dealers who are also registered in New Jersey and state-registered advisers. SEC-registered advisers are not covered.	"Fiduciaries" who provide investment advice for a fee or have discretion in the investment of plan assets within the meaning of ERISA. Discretionary advice is and has always been fiduciary activity.	Insurance producers (and insurers where no producer is involved).

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Emerging Investment Advice Framework, *continued*

	SEC- and State-Registered Investment Advisers	SEC-Registered Broker-Dealers (Under SEC Regulation Best Interest)	Proposed New Jersey Securities Regulation	ERISA Fiduciaries Subject to DOL Rules	Producers and Insurers Subject to New York Regulation 187
Can the scope of the duty owed to clients be modified via client consent?	An investment adviser's responsibilities and the scope and nature of services provided can be altered with client consent, but the fiduciary duty cannot be waived or changed by clients.	Unable to modify scope of best interest duty via client consent.	Not expressly addressed in regulation.	May specify by agreement the type and scope of services to be provided (e.g., manage the fixed-income sleeve of a defined benefit plan or advise as to the investment options for a defined contribution plan) but may not modify the statutory fiduciary duty.	No.
Is there an ongoing duty to monitor a client's account?	Generally yes, unless altered with client consent.	No ongoing duty to monitor investment performance. Duty extends only to the specific recommended securities transaction or investment strategy involving securities.	For broker-dealers, the fiduciary obligation extends through the execution of the recommendation. If a broker-dealer also provides investment advice in any capacity, has discretionary authority over a customer's account or a contractual fiduciary duty, the fiduciary duty will be applicable to the entire customer relationship, regardless of the customer account type.	Primarily a matter for agreement with the investor, although DOL has suggested a duty to monitor may be inherent in recommending more complex investments.	No.

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Can firms receive compensation from product issuers and other third parties?	Permissible to receive compensation from third parties if client consent is obtained and conflicts are mitigated. However, compensation cannot be paid for distribution or offering activity conducted on behalf of issuers without being registered as a broker-dealer and without such activity being subject to requirements applicable to broker-dealers.	Permissible if broker-dealers implement procedures to: (i) identify and at a minimum disclose, or eliminate, all conflicts of interest associated with recommendations; and (ii) identify and mitigate any conflicts of interest associated with recommendations that create an incentive to place the interests of the broker-dealer ahead of the interests of the customer.	There is a presumption of a breach of the duty of loyalty for offering or receiving direct or indirect compensation for recommending the opening of a specific type of account; the transfer of assets to a specific type of account; or the purchase, sale or exchange of a specific security that is not "the best of the reasonably available options." However, broker-dealers may receive transaction-based fees, provided that: (i) the fees are reasonable; (ii) the fees are the best of the reasonably available fee options; and (iii) the duty of care is satisfied.	Fiduciaries must not receive compensation from product issuers and other third parties unless a statutory or DOL-prohibited transaction exemption is applicable, which tend to be product-specific. Fiduciaries may avoid prohibited conflicts by crediting any value of the third-party compensation back to the plan, including through fee offsets or additional services.	Insurance producers may receive compensation from product issuers and other third parties so long as the amount of the compensation or the receipt of the incentive does not influence the recommendation. Insurers may maintain within and across product lines variations in compensation or other incentives that comply with New York insurance laws and regulations, provided the insurer's compensation and incentive practices, when taken as a whole, are designed to avoid recommendations by producers that are not in the best interests of consumers.

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Table 1
Emerging Investment Advice Framework, *continued*

	SEC- and State-Registered Investment Advisers	SEC-Registered Broker-Dealers (Under SEC Regulation Best Interest)	Proposed New Jersey Securities Regulation	ERISA Fiduciaries Subject to DOL Rules	Producers and Insurers Subject to New York Regulation 187
Are firms required to manage conflicts?	Yes. Investment advisers are required to eliminate or at least expose through full and fair disclosure all conflicts of interest, which might incline an investment adviser—consciously or unconsciously—to render advice that was not disinterested.	Yes. Broker-dealers must: (i) identify and at a minimum disclose, or eliminate, all conflicts of interest associated with recommendations; (ii) identify and mitigate any conflicts of interest associated with recommendations that create an incentive for a broker-dealer to place the interests of the broker-dealer ahead of the interests of the customer; (iii) identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a customer and any conflicts of interest associated with such limitations and prevent such limitations and associated conflicts of interest from causing the broker-dealer to make recommendations that place the interests of the broker-dealer ahead of the interests of the customer; and (iv) identify and eliminate any sales contests, sales quotas, bonuses and noncash compensation.	Yes. Broker-dealers and agents must make a reasonable inquiry, including risks, costs and conflicts of interest related to any recommendation or investment advice, and the customer's investment objectives, financial situation, needs and any other relevant information. Additionally, broker-dealers' and investment advisers' recommendations or advice must be made without regard to the financial or any other interests of the broker-dealer, agent, adviser, any affiliated or related entity and its officers, directors, agents, employees, contractors or any other third party.	Yes. Prohibited conflicts are allowable only to the extent permitted under an applicable statutory or DOL-prohibited transaction exemption, which regularly include conflict-mitigation conditions.	No express requirement imposed under the regulation to manage compensation-related conflicts. However, insurers are required to establish, maintain and audit a system of supervision that is reasonably designed to achieve the insurer's and producer's compliance with the best interest standard. Moreover, producer compensation arrangements and product-offering limitations are subject to specific disclosure requirements.

Table 1
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Are firms required to make disclosures?	Required by fiduciary duty and also specific requirement in Form ADV.	Prior to or at the time the recommendations are made, the broker-dealer must provide, in writing, full and fair disclosure of all material facts relating to the scope and terms of the brokerage relationship, including: (i) that the broker-dealer is acting as a broker-dealer with respect to the recommendation; (ii) the material fees and costs that apply to the customer's transactions, holdings and accounts; and (iii) the type and scope of services provided to the retail customer, including any material limitations on recommendations, and all material facts relating to conflicts of interest associated with the recommendation. Form CRS also would impose additional disclosure requirements for broker-dealers at the outset of the relationship.	No.	Prohibited conflicts are allowable only to the extent permitted under an applicable statutory or DOL-prohibited transaction exemption, which often require disclosures.	The best interest standard requires, among other things, that there be a reasonable basis to believe that the consumer has been reasonably informed of certain features of the policy and potential consequences of the transaction, both favorable and unfavorable.

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Can clients consent to activity that constitutes a conflict of interest?	Yes. Client consent is needed to proceed with activity that constitutes a conflict. Such consent may often be satisfied by full and fair disclosure.	Client consent not needed to proceed with activity that constitutes a conflict, although certain conflicts will need to be disclosed, mitigated or eliminated, regardless of client consent.	Not necessarily. There is no presumption that disclosing a conflict of interest in and of itself will satisfy the duty of loyalty.	No. Prohibited conflicts are allowable only to the extent permitted under an applicable statutory or DOL-prohibited transaction exemption, which often require consent from an independent fiduciary or plan participant.	Client consent is not needed to proceed with activity that constitutes a conflict.

Products and advisory services that present conflicts of interest for financial institutions are the impetus of the flurry of regulatory activity in this space. As a result, the regulations included in Table 1 could significantly alter the ways in which firms engage their customers, including the availability of certain product offerings or investment advice. Actuarial professionals should plan to be responsive to the needs of their financial institution partners as the emerging patchwork of investment advice regulation continues to develop.

For more commentary regarding the emerging landscape related to the standards of conduct for investment professionals, visit Eversheds Sutherland at *www.fiduciaryregulatory.com*. ■

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