Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest[1]

Background: The following is a staff bulletin styled as questions and answers reiterating the standards of conduct for broker-dealers and investment advisers in identifying and addressing conflicts of interest.[2] Importantly, both Regulation Best Interest ("Reg BI") for broker-dealers and the fiduciary standard for investment advisers under the Investment Advisers Act of 1940 (the "IA fiduciary standard") are drawn from key fiduciary principles that include an obligation to act in a retail investor's best interest and not to place their own interests ahead of the investor's interest.[3]

Under Reg BI and the IA fiduciary standard, a conflict of interest is an interest that might incline a broker-dealer or investment adviser—consciously or unconsciously—to make a recommendation or render advice that is not disinterested.[4] The staff believes that identifying and addressing conflicts should not be merely a "check-the-box" exercise, but a robust, ongoing process that is tailored to each conflict. It is therefore important that firms and their financial professionals review their business models and relationships with investors to address conflicts of interest specific to them.

Reg BI's obligation to act in the retail customer's best interest is satisfied by complying with the rule's four component obligations: Disclosure, Care, Conflict of Interest, and Compliance. The Conflict of Interest Obligation requires broker-dealers that make recommendations to retail customers to establish, maintain, and enforce written policies and procedures reasonably designed to:

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[1] This staff bulletin and other staff documents (including those cited herein) represent the views of the staff of the Securities and Exchange Commission ("Commission") and are not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved the content of these documents and, like all staff statements, they have no legal force or effect, do not alter or amend applicable law, and create no new or additional obligations for any person.

[2] For the purposes of this staff bulletin, we use the term "retail investor" to mean any person who qualifies as a "retail customer" as defined in Exchange Act rule 15*l*-1(b)(1), or a natural person client of an investment adviser. While this staff bulletin focuses on the obligations owed by a broker-dealer or investment adviser to retail investors, an investment adviser's fiduciary duty applies equally to all advisory clients (whether retail investors or otherwise).

[3] While the IA fiduciary standard duty generally applies to the entire advisory relationship with all clients, Reg BI's obligation to act in the best interest of the retail customer applies only when making a recommendation. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 84 FR 33669, 33670 (June 5, 2019) ("Fiduciary Interpretation"); Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031, 84 FR 33318, 33319 (June 5, 2019) ("Reg BI Adopting Release").

[4] *See* Exchange Act rule 15*l*-1(b)(3); *see also* Fiduciary Interpretation, *supra* note 3 (describing a Congressional intent to "eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested" and quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 US 180, 191-192 (1963)).

- identify and at a minimum disclose, or eliminate, all conflicts of interest associated with a recommendation;
- identify and mitigate (i.e., modify practices to reduce) conflicts of interest at the associated person level;
- identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer (e.g., only make recommendations of proprietary or other limited range of products) and any conflicts of interest associated with such limitations, and prevent such limitations and associated conflicts of interest from causing the broker-dealer, or a natural person who is an associated person of the broker-dealer, to make recommendations that place the interest of the broker-dealer or such natural person ahead of the interest of the retail customer; and
- identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.[5]

In addition, under the Disclosure Obligation, prior to or at the time of making a recommendation, a broker-dealer or associated person must make full and fair disclosure to the retail customer of all material facts relating to conflicts of interest that are associated with the recommendation.[6] Moreover, under the Compliance Obligation, a broker-dealer must establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI, including the Conflict of Interest Obligation. Finally, even if a broker-dealer has fulfilled these three component obligations, it has not fully complied with Reg BI unless it has also satisfied the Care Obligation, which includes a requirement for broker-dealers and their associated persons to have a reasonable basis to believe that each recommendation or series of recommendations made is in the best interest of the particular retail customer and does not place their financial or other interests ahead of the interest of the retail customer.

Investment advisers are subject to the IA fiduciary standard, which encompasses both the duty of loyalty and duty of care. Under the duty of loyalty, investment advisers must eliminate a conflict of interest or, at a minimum, make full and fair disclosure of the conflict of interest such that a client can provide informed consent to the conflict.[7] The duty of care requires, among other things, investment advisers to provide investment advice in the client's best interest, based on a reasonable understanding of the client's objectives.[8] This combination of loyalty and care

[5] *See* Exchange Act rule 15*l*-1(a)(2)(iii); Reg BI Adopting Release, *supra* note 3, at 33331.

[6] *See* Exchange Act rule 15*l*-1(a)(2)(i)(B); Reg BI Adopting Release, *supra* note 3, at 33347 (noting that "[a]s to what constitutes a 'material' fact related to the "'scope and terms of the relationship,'" the standard for materiality for purposes of the Disclosure Obligation is consistent with the one the Supreme Court articulated in *Basic v. Levinson*").

[7] *See* Fiduciary Interpretation, *supra* note 3, at 33671.

[8] *See id.* at 33672-74.

obligations has been characterized as requiring an investment adviser to act in its client's "best interest" at all times.[9]

Investment advisers also must adopt and implement policies and procedures reasonably designed to prevent violations, by the adviser and its supervised persons, of the Advisers Act and the rules thereunder, which includes preventing breaches of the IA fiduciary standard in violation of section 206 of the Advisers Act.[10] The Commission has stated that, in complying with the Advisers Act compliance rule, investment advisers registered or required to be registered with the Commission should adopt policies and procedures addressing the creation and maintenance of required records.[11] In the staff's view, it would be difficult for an investment adviser to demonstrate how it complies with its fiduciary obligations in the absence of records related to how the adviser addresses its conflicts.

This staff bulletin is designed to assist firms and their financial professionals with addressing conflicts of interest such that they comply with their obligations to provide advice and recommendations in the best interest of retail investors. It should be read in conjunction with, among other sources, Reg BI as well as the specific Commission releases discussing Reg BI and the IA fiduciary standard.[12] In addition, the staff has made available other resources, including a variety of staff FAQs addressing compliance with Form CRS, Reg BI and the IA fiduciary standard, risk alerts, and other statements highlighting relevant compliance practices and staff observations.[13]

Questions:

Identifying Conflicts of Interest

1. **Do all broker-dealers and investment advisers have conflicts of interest?**

Yes. All broker-dealers, investment advisers, and financial professionals have at least some conflicts of interest with their retail investors. Specifically, they have an economic incentive to recommend products, services, or account types that provide more revenue or other benefits for the firm or its financial professionals, even if such recommendations or advice are not in the best

[9] *See id.* at 33671.

[10] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) ("Advisers Act Compliance Rule Adopting Release"); *see also* Advisers Act rule 204-2(a)(7).

[11] *See* Advisers Act Compliance Rule Adopting Release, *supra* note 10.

[12] *See* Reg BI Adopting Release, *supra* note 3; Fiduciary Interpretation, *supra* note 3.

[13] *See* SEC Spotlight, Regulation Best Interest, Form CRS and Related Interpretations, *available at* https://www.sec.gov/regulation-best-interest. The staff of the Divisions of Trading and Markets and Investment Management has previously published a staff bulletin that discusses examples of practices that can assist firms in meeting their obligations relating to account type recommendations. *See* Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors, *available at* https://www.sec.gov/tm/iabd-staff-bulletin ("Staff Bulletin on Account Recommendations").

interest of the retail investor.[14] This can create substantial conflicts of interest for both firms and financial professionals.

The nature and extent of conflicts will depend on various factors, including a firm's business model. Consistent with their obligation to act in a retail investor's best interest, firms must address conflicts in a way that will prevent the firm or its financial professionals from providing recommendations or advice that places their interests ahead of the interests of the retail investor.

2. What are some examples of conflicts of interest for broker-dealers, investment advisers, or financial professionals?

Under both standards, a conflict of interest is an interest that might incline a broker-dealer, investment adviser, or financial professional—consciously or unconsciously—to make a recommendation or render advice that is not disinterested. Examples of common sources of conflicts of interest can include, but are not limited to:

- compensation, revenue or other benefits (financial or otherwise) to the firm or its affiliates, including fees and other charges for the services provided to retail investors (for example, compensation based on assets gathered and/or products sold, including but not limited to receipt of assets under management ("AUM") or engagement fees, commissions, markups, payment for order flow, cash sweep programs, or other sales charges) or 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);
- compensation, revenue or other benefits (financial or otherwise) to financial professionals from their firm or its affiliates (for example, compensation or other rewards associated with quotas, bonuses, sales contests, special awards; differential or variable compensation based on the product sold, accounts recommended, AUM, or services provided; incentives tied to appraisals or performance reviews; forgivable loans based upon the achievement of specified performance goals related to asset accumulation, revenue benchmarks, client transfer, or client retention);
- compensation, revenue or other benefits (financial or otherwise) (including, but not limited to, gifts, entertainment, meals, travel, and related benefits, including in connection with the financial professional's attendance at third-party sponsored trainings and conferences) to the financial professionals resulting from other business or personal relationships the financial professional may have, relationships with third parties that may relate to the financial professional's association or affiliation with the firm or with another firm (whether affiliated or unaffiliated), or other relationships within the firm; and

[14] The staff of the Division of Investment Management also has published FAQs relating to financial conflicts for investment advisers relating to compensation received in connection with investments they recommend. *See* Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation, *available at* https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation; *see also* Reg BI Adopting Release, *supra* note 3, at 33319 n. 6 (noting that, like many principal-agent relationships, broker-dealers' and investment advisers' relationships with retail investors have inherent conflicts of interest).

- compensation, revenue or other benefits (financial or otherwise) to the firm or its affiliates resulting from the firm's or its financial professionals' sales or offer of proprietary products or services, or products or services of affiliates.

While the examples above represent some common sources of conflicts of interest, the staff notes that there are other sources of conflicts that firms and their financial professionals may need to consider in light of their specific business models.

3. Is my firm expected to identify conflicts of interest?

Yes. Under Reg BI, broker-dealers must establish, maintain and enforce written policies and procedures reasonably designed to identify all conflicts of interest associated with recommendations to retail customers.[15] Broker-dealers are expected to identify conflicts of interest on an ongoing basis and periodically review their policies and procedures for compliance with Reg BI.[16] Under the Advisers Act, the Commission has stated that investment advisers, as part of designing their written compliance policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations.[17] Investment advisers also must review, no less frequently than annually, the adequacy of such policies and procedures and the effectiveness of their implementation.[18]

4. What are some steps my firm can take to identify conflicts of interest?

While the appropriate steps will depend on a firm's specific business model, the staff believes that broker-dealers and investment advisers should consider the following non-exhaustive steps to identify conflicts of interest, and consider including such steps in their policies and procedures:

- define conflicts in a manner that is relevant to the firm's business, including conflicts of the firm, its financial professionals and any affiliates (who may have their own independent conflicts in addition to those shared with the firm), and in a way that enables appropriate personnel, including compliance professionals, to understand and identify conflicts of interest;

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[15] *See* Reg BI Adopting Release, *supra* note 3, at 33388 (providing guidance to broker-dealers relating to the requirement to establish, maintain and enforce written policies and procedures reasonably designed to identify conflicts of interest).

[16] *Id*. (providing guidance to broker-dealers that reasonably designed policies and procedures generally should "provide for an ongoing (e.g., based on changes in the broker-dealer's business or organizational structure, changes in compensation incentive structures, and introduction of new products or services) and regular, periodic (e.g., annual) review for the identification of conflicts associated with the broker-dealer's business"); *id*. at 33397-98 ("[A] reasonably designed compliance program generally would also include: . . . periodic review and testing.").

[17] *See* Advisers Compliance Rule Adopting Release, *supra* note 10, at 74716.

[18] *See* Advisers Act rule 206(4)-7(b).

- define conflicts in a manner that includes conflicts that arise across the scope of advice or recommendations associated with the relationship with the retail investor (such as conflicts associated with account recommendations; allocation of investments among accounts; allocation of investment opportunities among retail investors, such as initial public offering allocations; and cash management services);
- establish a process to identify the types of conflicts that the firm and its financial professionals may face and how such conflicts might impact advice or recommendations;[19]
- provide for an ongoing (for example, based on changes in the firm's business or organizational structure, changes in compensation structures, and introduction of new products or services) and regular, periodic process to identify conflicts associated with the firm's business; and
- establish, and publish internally or otherwise communicate, training programs regarding conflicts of interest, including conflicts associated with the firm's financial professionals (both within and outside the financial professionals' association with the firm) and any affiliates, and how to identify such conflicts of interest, as well as defining employees' and financial professionals' roles and responsibilities with respect to identifying such conflicts of interest and bringing any conflicts to management's attention.[20]

Finally, the staff believes that firms should establish a "culture of compliance." As applied to conflicts of interest, creating an environment where conflicts are taken seriously and financial professionals feel empowered and encouraged to take an active role in identifying conflicts so that they may be adequately addressed may significantly decrease the likelihood of a violation.

5. My firm has identified all of its conflicts of interest. Once the firm discloses the conflicts to retail investors, have we satisfied our obligations under Reg BI and the IA fiduciary standard?

No. Disclosure of conflicts alone does not satisfy the obligation to act in a retail investor's best interest. Further, as discussed below, certain conflicts should (and in some cases, must) be addressed through mitigation.[21] Where such 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 to avoid violating the

[19] *See, e.g.*, In the Matter of Knowledge Leaders Capital, LLC, Investment Advisers Act Release No. 4980 (Aug. 9, 2018) (settled action) (investment adviser failed to identify (and as a result, failed to disclose to clients) the financial conflicts of interest created by adviser using soft dollars to pay a company owned and controlled by adviser's Chief Investment Officer), *available at* https://www.sec.gov/litigation/admin/2018/ia-4980.pdf.

[20] *See* Reg BI Adopting Release, *supra* note 3, at 33388 (providing similar guidance for broker-dealers).

[21] *See* Reg BI Adopting Release, *supra* note 3, at 33331 (noting that broker-dealers must establish, maintain, and enforce written policies and procedures reasonably designed to, among other things, mitigate conflicts of interest at the associated person level); Fiduciary Interpretation, *supra* note 3, at 33677 ("In all of these cases where an investment adviser cannot fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent, the adviser should either *eliminate* the conflict or adequately *mitigate* (*i.e.*, modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible.").

obligation to act in a retail investor's best interest in light of the investor's objectives.[22] Moreover, even if conflicts are sufficiently addressed, under both Reg BI and the IA fiduciary standard, firms and their financial professionals can provide recommendations or advice only when they have a reasonable basis to believe that the recommendation or advice is in the retail investor's best interest.

Eliminating Conflicts of Interest

6. Are there circumstances when a particular conflict should be eliminated?

Yes. Broker-dealers and investment advisers have an obligation to act in the retail investor's best interest, including, when appropriate, eliminating conflicts. Reg BI explicitly requires broker-dealers to have written policies and procedures reasonably designed to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.[23]

Investment advisers must fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent. If the client cannot provide informed consent because, for example, the conflict is of a nature and extent that it would be difficult for the adviser to provide full and fair disclosure, and the investment adviser cannot mitigate the conflict such that full and fair disclosure and informed consent are possible, the staff believes that the adviser should eliminate the conflict.

Firms 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. In such cases, firms may need to determine whether to eliminate the conflict or refrain from providing advice or recommendations that could be influenced by the conflict to avoid violating the obligation to act in the retail investor's best interest.

This can arise, as one example, when a firm adopts a compensation or incentive program that provides 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 staff's view, the greater the reward to the financial professional for meeting particular thresholds (or conversely, the more severe the consequence for failing to meet them), the greater is the concern whether the incentive

[22] *See* Fiduciary Interpretation, *supra* note 3, at 33677. Broker-dealers also must eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time. *See* Exchange Act rule 15*l*-1(a)(2)(iii)(D). In addition, for those sales contests, sales quotas, bonuses, non-cash compensation, or other incentives that are not explicitly prohibited under Reg BI, if firms determine that the conflicts associated with them are too difficult to mitigate and disclose, the firm should consider carefully assessing whether it is able to satisfy its best interest obligation in light of the identified conflict and in certain circumstances, may wish to avoid such practice entirely. *See* Reg BI Adopting Release, *supra* note 3, at 33397.

[23] *See* Exchange Act rule 15*l*-1(a)(2)(iii)(D).

program complies with Reg BI and the IA fiduciary standard. In cases where the firm finds that a particular incentive practice is causing its financial professionals to place the firm's or the financial professional's interest ahead of the retail investor's interest, the firm may need to revise its incentive program to reduce or eliminate the conflict.[24]

Mitigating Conflicts of Interest

7. What factors are relevant to a firm's approach to mitigating conflicts of interest?

The staff believes that the appropriate conflicts of interest mitigation measures will depend on the nature and significance of the incentives provided to the firm or its financial professionals and a firm's business model. In the staff's view, some factors related to the nature and significance of the incentives and the firm's business model may include, but are not limited to:

- the sources of the firm's compensation, revenue, or other benefits (financial or otherwise), whether or not it receives them directly from the retail investor;
- the extent to which a firm's revenues vary based on the type of account, products (including but not limited to share classes recommended), services recommended, or AUM;
- whether or not the firm or its affiliates recommend or provide advice about proprietary products;
- the extent to which the firm uses incentives to encourage financial professionals to recommend or provide advice about accounts or investment products that are more profitable for the firm;
- the extent to which the compensation of financial professionals varies based on the investment product recommended (e.g., variable compensation for similar securities);
- the nature of the payment structure for financial professionals (e.g., whether retrospective, the steepness of the increases between levels);
- the size or structure (e.g., broker-dealer, investment adviser, or dual registrant) of the firm or if the firm's financial professionals are dually licensed or engage in activities outside of the firm;[25]
- whether the firm shares dually licensed financial professionals with affiliates or third parties;
- retail investor base (e.g., diversity of investment experience, total assets, and financial needs); and
- the complexity of the security or investment strategy involving securities that are recommended.[26]

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[24] *See supra* note 21 (discussing broker-dealers' and investment advisers' mitigation obligations); *see also supra* note 19.

[25] Reg BI's requirement of written policies and procedures reasonably designed to mitigate certain incentives to an associated person would not apply to compensation that is not an incentive provided by or in the control of the broker-dealer. *See* Reg BI Adopting Release, *supra* note 3, at 33391 n. 744.

[26] *See* Staff Bulletin on Account Recommendations, *supra* note 13 (discussing conflicts of interest relating to account type recommendations).

Firms should consider their specific business model in determining how these or other relevant factors impact the conflict they are seeking to mitigate.

8. Should my firm address conflicts of interest concerning compensation arrangements for financial professionals?

Yes. The decisions firms make about compensation and incentives paid to financial professionals can give rise to conflicts of interest that could affect recommendations or advice to retail investors. Firms should carefully consider, when establishing compensation and incentive programs, if the arrangements could cause their financial professionals (either consciously or unconsciously) to provide advice or make recommendations that place the interests of the firm or the financial professional ahead of the retail investor's interests. In some cases, in order to avoid violating the obligation to act in the retail investor's best interest, firms may be required to eliminate the conflict or refrain from providing advice or recommendations that are influenced by the conflict.

Reg BI explicitly requires that broker-dealers establish, maintain, and enforce written policies and procedures reasonably designed to identify and mitigate conflicts of interest at the associated person level (*i.e.*, incentives that directly affect the associated person making a recommendation).[27] The staff believes that investment advisers also should consider such policies and procedures to help ensure that they and their financial professionals do not violate the antifraud provisions of the federal securities laws through a breach of fiduciary duty.[28]

For example, the staff believes a firm should assess the types of conflicts that may arise from its compensation practices for financial professionals, including but not limited to:

- whether the firm's compensation practices incentivize its financial professionals to offer advice and recommendations that are not in their retail investors' best interests;
- whether the basis for calculating financial professionals' compensation has the effect of passing along firm-level conflicts to their financial professionals, such as incentivizing financial professionals to recommend or provide advice about certain products, account types, or services to investors that are most profitable for the firm; and
- whether its financial professionals also receive other types of compensation or benefits, such as trips and meals paid for by a third party, that may create conflicts of interest between the financial professional and the firm's retail investors, and whether the firm has policies and procedures and other systems in place to identify and address any such conflicts.

[27] *See* Reg BI Adopting Release, *supra* note 3, at 33391 (providing examples of such conflicts).

[28] *See* Advisers Act Compliance Rule Adopting Release, *supra* note 10, at 74716 ("Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.").

While compensation practices for financial professionals are an important potential source of conflicts of interest, the staff reminds firms that mitigating conflicts associated with these practices is just one aspect of how firms satisfy their conflict obligations.[29] The staff reminds firms that they also must address conflicts at the firm level such that they satisfy their obligation to act in the retail investor's best interest.

9. What are some examples of potential mitigation methods for compensation arrangements for financial professionals?

Firms may adopt a range of measures to mitigate conflicts of interest for compensation arrangements for financial professionals, depending on the nature and magnitude of the conflicts they seek to address. The staff believes the following non-exhaustive list of practices could be used as potential mitigation methods for firms to comply with their obligations to retail investors under the standards:

- avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales of certain products or provision of certain services;
- minimizing compensation incentives for financial professionals to favor one type of account over another, or to favor one type of product over another (e.g., products that provide third-party compensation, such as revenue sharing, proprietary or preferred provider products, or comparable products sold on a principal basis), for example by basing differential compensation on neutral factors;
- eliminating compensation incentives within comparable product lines by, for example, capping the credit that financial professionals may receive across mutual funds, annuities, real estate investment trusts ("REITs"), or other comparable products across providers;
- implementing supervisory procedures to monitor recommendations or ongoing advice that result in additional compensation that: is near compensation thresholds; is near thresholds for firm recognition; or involve higher compensating products, proprietary products, or transactions that provide more compensation to the firm or financial professional;
- adjusting compensation for financial professionals who fail to manage their conflicts of interest adequately and to bring any conflicts to management's attention;
- limiting the types of products, transactions, or strategies certain financial professionals may recommend; and[30]

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[29] *See* Fiduciary Interpretation, *supra* note 3, at 33677 ("In all of these cases where an investment adviser cannot fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent, the adviser should either eliminate the conflict or adequately mitigate (i.e., modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible."); Reg BI Adopting Release, *supra* note 3, at 33390 (noting that, although broker-dealers are not required to mitigate all firm-level financial incentives, they must still develop written policies and procedures to mitigate or eliminate certain conflicts of interest, either at the associated person or firm level, that may have a potential impact on recommendations to retail customers). *See also supra* note 9 and accompanying text.

[30] The staff of the Division of Trading and Markets also has published an FAQ regarding mitigation methods under Reg BI. *See* Frequently Asked Questions on Regulation Best Interest ("Reg BI FAQs"), *available at* https://www.sec.gov/tm/faq-regulation-best-interest#conflict-of-interest.

- providing training and guidance to financial professionals on evaluating, selecting, and, as required, monitoring investments in the best interests of retail investors.

Depending on the circumstances, other mitigation measures may be necessary or, in some instances, it may not be possible to mitigate the conflict of interest.

Although industry practice may be a useful guide, the sufficiency of any mitigation of conflicts of interest is not assessed by comparison to industry practice alone. In the staff's view, periodic review and testing of policies and procedures is necessary to ensure the on-going adequacy and effectiveness of a compliance program. The staff believes this should include a periodic assessment of whether a firm's policies and procedures are reasonably designed to disclose and mitigate, as necessary, the impact of conflicts and prevent the firm's or its financial professionals' interests from being placed ahead of the retail investor's interest. In the staff's view, it may 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 and any such periodic assessment of its policies and procedures undertaken by the firm.

The staff also reminds firms that to satisfy their obligation to act in the retail investor's best interest a firm must address conflicts at both the firm level and financial professional level.

Product Menus

10. Do I need to address conflicts of interest concerning a recommendation or advice that is limited to a menu of certain products?

Yes. A firm's product menu can have a significant impact on the conflicts of interest present in its business model. The staff believes that firms should carefully consider how their product menu choices—which could include limitations such as offering only proprietary products (i.e., any product that is managed, issued, or sponsored by the firm or any of its affiliates), a specific asset class, or products that pay revenue sharing or feature similar third-party arrangements—comply with the firm's obligations to act in the best interest of retail investors when providing investment advice and recommendations and to disclose conflicts.[31]

For example, firms should evaluate whether a limited product menu or otherwise limiting the range of products offered, such as share classes offered, (either by the firm or an affiliate) creates a conflict that could incline the firm or its financial professionals to offer advice or make recommendations that place the interests of the firm or its financial professionals ahead of the retail investor's interest. In the staff's view, firms should consider establishing product review processes for the products they offer (or that are offered by an affiliate). Such a product review process could include, for example:

[31] *See* Exchange Act rule 15*l*-l(a)(2)(iii)(C) (requiring broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to identify and disclose material limitations and associated conflicts and to prevent the limitations from causing the financial professional or broker-dealer from placing the associated person's or broker-dealer's interests ahead of the customer's interest); s*ee* Fiduciary Interpretation, *supra* note 3, at 33676 (a dual registrant, acting in an advisory capacity, should disclose any circumstances in which its advice will be limited to certain products offered through its affiliated broker-dealer or affiliated investment adviser).

- identifying and mitigating the conflicts of interest associated with the product, such as payments for inclusion on a firm's menu of products offered (sometimes referred to as shelf space);
- declining to recommend or provide advice with regard to a product where the firm cannot effectively mitigate the conflict;
- evaluating the use of "preferred lists";[32]
- restricting the retail investors to whom certain products may be recommended;
- prescribing minimum knowledge and/or training requirements for financial professionals who may provide recommendations or advice with regard to certain products;[33] and
- conducting periodic product reviews to identify potential conflicts of interest, whether the measures addressing conflicts are working as intended, and to modify the measures or product selection accordingly.

In addition to addressing conflicts associated with product menus, under Reg BI, broker-dealers also must identify and disclose any material limitations placed on the securities or investment strategies that may be recommended to a retail customer and any conflicts of interest associated with such limitations.[34] In the staff's view, the product review processes described above could equally apply to limitations placed on investment strategies and investment advisers. For example, a dual registrant acting in its advisory capacity should disclose any circumstances under which its advice will be limited to a menu of certain products offered through its affiliated broker-dealer or affiliated investment adviser.[35] Investment advisers therefore should consider addressing any such circumstances in which their advice will be similarly limited.

[32] *See* Reg BI Adopting Release, *supra* note 3, at 33393 (citing FINRA Report on Conflicts of Interest (Oct. 2013), *available at* https://www.finra.org/sites/default/files/Industry/p359971.pdf (stating that conflicts can arise when a firm places products in which it receives revenue sharing payments on a "preferred list" of products the firms offer).

[33] *See, e.g.*, In the Matter of Securities America Advisors, Inc., Investment Advisers Act Release No. 5627 (Nov. 13, 2020) (settled action) (investment adviser failed to implement existing policies and procedures to determine whether adviser representatives were fulfilling their fiduciary obligations when investing clients in, or recommending, volatility-linked exchange-traded products ("ETPs"), including failing to implement policies and procedures requiring that representatives have the training necessary for them to have an "adequate basis" to make recommendations to, and investments for, clients that were consistent with client investment objectives and risk profiles), *available at* https://www.sec.gov/litigation/admin/2020/ia-5627.pdf.

[34] *See* Reg BI Adopting Release, *supra* note 3, at 33393 (requiring broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to identify and disclose any material limitations placed on recommended securities or investment strategies in accordance with Reg BI's Disclosure Obligation).

[35] *See* Fiduciary Interpretation, *supra* note 3, at 33676.

Disclosing Conflicts of Interest

11. How should my firm satisfy its obligations to disclose conflicts of interest fully and fairly?

Disclosures should be designed to allow retail investors to make a more informed decision about a recommendation, and, in the case of investment advisers, provide informed consent to the conflict of interest.[36] Broker-dealers must, at a minimum, fully and fairly disclose all material facts relating to a conflict of interest that might incline the firm or its financial professionals to make a recommendation or provide advice that is not disinterested. Information is material if there is a substantial likelihood that a reasonable retail investor would consider it important.[37] Investment advisers must eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser–consciously or unconsciously–to render advice which is not disinterested such that a client can provide informed consent to the conflict.[38]

As stated above, the staff cautions firms that disclosure should not be merely a "check-the-box" exercise. The staff believes that disclosures should be specific to each conflict, in "plain English," and tailored to, among other things, firms' business models, compensation structures, and products offered at different firms. Stating that a firm "may" have a conflict when the conflict actually exists is not sufficiently specific to disclose the conflict adequately to retail investors.[39]

Additionally, the nature and extent of some conflicts may make it difficult to convey adequately to a retail investor through disclosure the material facts or the nature, magnitude, and potential effects of the conflict. Some conflicts also are difficult to disclose comprehensibly or with sufficient specificity to enable the retail investor to understand whether and how the conflict could affect the recommendation or advice they receive. In these circumstances, if the conflict cannot be fully and fairly disclosed, the firm should consider mitigation or elimination to address the conflict sufficiently.

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[36] For investment advisers, such disclosures should be sufficiently specific so that a retail investor is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent. *See* Fiduciary Interpretation, *supra* note 3, at 33677. In the case of broker-dealers, the disclosure should give sufficient information to allow a retail customer to make a more informed decision with regard to the recommendation. *See also* Reg BI Adopting Release, *supra* note 3, at 33365.

[37] *See* Reg BI Adopting Release, *supra* note 3, at 33362.

[38] *See* Fiduciary Interpretation, *supra* note 3, at 33677 (discussing the difficulty of providing adequate disclosure to retail clients for complex or extensive conflicts).

[39] *See id.*, at 33364, n. 467 and accompanying text ("[D]isclosure that an adviser 'may' have a particular conflict, without more, is not adequate when the conflict actually exists.") (citing *In the Matter of The Robare Group*, Investment Advisers Act Release No. 4566 (Nov. 7, 2016) (Commission Opinion) (finding, among other things, that an adviser's disclosure that it may receive a certain type of compensation was inadequate because it did not reveal that the adviser actually had an arrangement pursuant to which it received fees that created a conflict of interest); *aff'd in relevant part by Robare Group v. SEC*, 922 F.3d 468 (D.C. Cir. 2019) (denying petition challenging the SEC's finding that the Petitioners violated section 206(2) of the Advisers Act)).

12. What are examples of facts relating to conflicts of interest associated with compensation or benefits that should be disclosed to retail investors?

As stated above, compensation arrangements, or other arrangements conferring benefits, can create substantial conflicts of interest for both firms and financial professionals, but the precise nature of those arrangements and conflicts may vary. The conflicts of interest associated with these varying arrangements, including but not limited to how a firm's financial professionals are compensated must be disclosed.[40]

When the conflict concerns compensation or other benefits, in the staff's view, facts disclosed should, at a minimum, include:

- the nature and extent of the conflict;
- the incentives created by the conflict and how the conflict affects or could affect the recommendation or advice provided to the retail investor (for example, where the availability of products that can be recommended to the retail investor is limited as a result of the financial professional only recommending products from certain preferred providers);
- the source(s) and scale of compensation for the firm and/or financial professional;
- how the firm and/or financial professional is compensated for, or otherwise benefits from, their recommendation or advice (for example, revenue sharing or other compensation related to cash sweep programs) and what, if any additional benefits they may receive (for example, cost reductions, merchandise, gifts, or prizes); and
- the nature and extent of any costs or fees incurred, directly or indirectly, by the retail investor as a result of the conflict.[41]

a. How should my firm disclose facts regarding conflicts of interest when providing advice about or recommending proprietary products to retail investors?

When broker-dealers and investment advisers are recommending or providing advice about proprietary products, in the staff's view, facts regarding the conflicts of interest that should be disclosed include, as relevant:

- whether the firm or an affiliate manages, issues, or sponsors the product;

[40] *See, e.g.*, Reg BI Adopting Release, *supra* note 3, at 33363 ("compensation associated with recommendations to retail customers and related conflicts of interest—whether at the broker-dealer or the associated person level—is a conflict of interest about which material facts must be disclosed as part of the Disclosure Obligation"); *see also* Instruction to Item 5.E.1 of Part 2 of Form ADV (requiring advisers to explain that any compensation the adviser or its affiliated person receives for the sale of securities or other investment products presents a conflict of interest and provides an incentive to recommend investment products based on the compensation received, rather than on a client's needs).

[41] *See, e.g.*, Reg BI Adopting Release, *supra* note 3, at 33363 (explaining costs and fees paid by retail customers may directly or indirectly be the source of compensation, for example, where a broker-dealer receives compensation derived from the sale of securities or other investment products held by retail investors of the firm, including asset-based sales charges or service fees on mutual funds).

- whether the firm, its financial professionals or an affiliate could receive additional fees and compensation related to that product;[42]
- whether the firm prefers, targets, or limits its recommendation or advice to proprietary products or only those proprietary products for which the firm or an affiliate could receive additional fees and compensation;[43] and
- the extent to which financial professionals receive additional compensation, have quotas to meet, or qualify for bonuses or awards based on their sale of proprietary products (such as mutual funds, annuities or REITs).

b. In addition, how should my firm disclose conflicts of interest created by third party compensation?

When there is a conflict created by firms or their financial professionals receiving compensation from third parties, whether or not sales-related (including, but not limited to, revenue sharing, sub-accounting, administrative services fees paid by a fund or its adviser), in the staff's view, broker-dealers, investment advisers, or their financial professionals, should disclose the existence and effects of such incentives provided to the firm or shared between the firm and others. In addition to the conflicts of interest described above in Question 12.a, the following is a non-exhaustive list of examples of third party compensation incentives potentially present at both broker-dealers and investment advisers:

- offering a limited product menu from which recommendations are made or advice is provided based on preferred providers or investments;
- agreements to receive payments from a clearing broker for recommending that the adviser's clients invest in no-transaction-fee or sales load mutual fund share class offered on the clearing broker's platform;
- any agreements to receive payments, loan forgiveness, and/or expense offsets from a custodian for recommending that the firm's retail investor maintain assets at the custodian; and

[42] *See, e.g.*, In the Matter of SoFi Wealth, LLC, Investment Advisers Act Release No. 5826 (Aug. 19, 2021) (settled action) (registered investment adviser breached its fiduciary duty by transferring client assets out of third-party exchange-traded funds into adviser's proprietary exchange-traded funds, for which the adviser could receive a fee, without disclosing, among other things, the conflict of interest arising from adviser's preference for its proprietary products), *available at* https://www.sec.gov/litigation/admin/2021/ia-5826.pdf. *See also, e.g.*, In the Matter of BMO Harris Financial Advisors, Inc., Investment Advisers Act Release No. 5377 (Sept. 27, 2019) (settled action) (registered investment adviser violated Advisers Act's anti-fraud provisions by, among other things, failing to disclose adviser's practice of maintaining approximately 50% of advisory program assets in proprietary mutual funds, from which adviser could earn management and administrative fees), *available at* https://www.sec.gov/litigation/admin/2019/34-87145.pdf. Broker-dealers making recommendations of securities or investment strategies involving securities to retail investors must have written policies and procedures reasonably designed to identify and eliminate any sales contests, sales quotes, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time. *See supra* note 23.

[43] Exchange Act rule 15*l*-l(a)(2)(iii)(C)(1) (requiring broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose any material limitations placed on the securities or investment strategies involving securities and any conflicts of interest associated with such limitations).

- any arrangements where the firm is compensated by mutual funds, exchange-traded funds, or other financial products out of product fees or by the products' sponsors, or other revenue-sharing arrangements.[44]

c. How should my firm disclose conflicts of interest when recommending wrap fee and other separately managed account programs to retail investors?

When recommending wrap fee and other separately managed account programs, in the staff's view, facts that should be disclosed include those that could encourage the broker-dealer or investment adviser to recommend a wrap account or separately managed account. These would include, for example, any compensation from wrap fee program sponsors (including affiliates) for investing client assets in the sponsors' programs and the possibility that the investor will bear higher costs by participating in the wrap fee program than in other types of accounts. Firms also should consider the scope of the relationship with respect to the account and whether there is an obligation or agreement to monitor the account and, as applicable, disclose any incentive to not migrate infrequently traded wrap fee accounts to brokerage or non-wrap advised accounts (sometimes referred to as "reverse churning").[45] The staff also believes that material facts include those that could impact the firm's recommendations based on how the account is managed, particularly when the firm is recommending its own account program. For example, firms should consider disclosure regarding a manager's financial incentives: (1) to invest assets in share classes that provide higher compensation to the firm; and (2) to not trade, or trade rarely, in accounts because the firm may be responsible for paying ticket charges or other costs.[46]

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[44] The Commission has settled enforcement actions against investment advisers where conflicts associated with mutual fund share class or cash sweep vehicle selection led to violation of their duty to seek best execution in addition to charges of failure to disclose conflicts of interest. *See, e.g.*, In the Matter of 1st Global Advisors, Inc., Investment Advisers Act Release No. 5932 (Dec. 20. 2021) (settled action), *available at* https://www.sec.gov/litigation/admin/2021/ia-5932.pdf; In the Matter of Rothschild Investment Corp., Investment Advisers Act Release No. 5860 (Sept. 13, 2021) (settled action), *available at* https://www.sec.gov/litigation/admin/2021/34-92951.pdf.

[45] *See* Fiduciary Interpretation, *supra* note 3, at 33675 (discussing an investment adviser's duty to provide advice and monitoring over the course of the relationship, taking into account the scope of the agreed relationship); *see also, e.g.*, In the Matter of Raymond James & Associates, Inc., et al., Investment Advisers Act Release No. 5352 (Sep. 17, 2019) (settled action) (investment adviser failed to adequately and timely conduct a suitability review for inactive accounts described in its brochure and policies and procedures), *available at* https://www.sec.gov/litigation/admin/2019/33-10689.pdf. *See* Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion From the Definition of Investment Adviser, Investment Advisers Act Release No. 5249, 84 FR 33681, 33686-87 (June 5, 2019) (discussing account monitoring by broker-dealers as it relates to their status as an investment adviser). S*ee also* Reg BI Adopting Release, *supra* note 3, at 33221 (Regulation Best Interest does not impose on a broker-dealer a duty to provide ongoing advice and monitoring).

[46] *See, e.g.*, In the Matter of Northwest Advisors, Inc., Investment Advisers Act Release No. 5830 (Aug. 24, 2021) (settled action) (investment adviser failed to adequately disclose its practice of investing program assets in mutual fund share classes that would charge a higher fee to clients and benefit the adviser through avoidance of transaction fees), *available at* https://www.sec.gov/litigation/admin/2021/ia-5830.pdf; In the Matter of Pruco Securities LLC, Investment Advisers Act Release No. 5657 (Dec. 23, 2020) (settled action) (investment adviser failed to disclose conflicts of interest related to financial incentives to select investments that avoid certain transaction costs the adviser would otherwise bear), *available at* https://www.sec.gov/litigation/admin/2020/34-90790.pdf.

While firms should disclose the existence and potential effects of such conflicts, the staff reminds firms that disclosure of conflicts alone does not satisfy a firm's obligation to act in the retail investor's best interest.[47]

13. My firm has established policies and procedures to identify and address my firm's conflicts of interest through a combination of elimination, mitigation, and disclosure. Can we stop worrying about this now?

No. The staff believes that identifying and addressing conflicts is not a "set it and forget it" exercise. Firms should monitor conflicts over time and assess periodically the adequacy and effectiveness of their policies and procedures to help ensure continued compliance with Reg BI and the IA fiduciary standard. Reasonably designed policies and procedures that address conflicts may later cease to be reasonably designed based on subsequent events or information obtained, such as through supervision (e.g., exception testing of recommendations), and the actual experience of the firm.[48]

Given that the ultimate goal of establishing policies and procedures to address conflicts of interest is to prevent firms and financial professionals from placing their interests ahead of retail investors' interests, in the staff's view, it is especially important that firms periodically review their recommendations and advice to ensure that this goal is being met. In order to demonstrate compliance under Reg BI and the IA fiduciary standard, in the staff's view, a firm should consider documenting the measures it takes to address and monitor conflicts of interest.

[47] *See* HighPoint Advisor Group, LLC, Investment Advisers Act Release No. 6003 (Apr. 27, 2022) (settled action) (investment adviser breached its duty of care, including its duty to seek best execution, when it advised certain wrap clients to invest in certain fund share classes when other share classes of the same funds that presented a more favorable value were available to the clients and without undertaking any analysis to determine whether such share classes were in the best interests of those clients), *available at* https://www.sec.gov/litigation/admin/2022/ia-6003.pdf.

[48] A well thought out and well-designed compliance program should be flexible enough to adjust to known variables in operations and business, but should also have established processes in place to monitor effectiveness and to pivot or be updated when appropriate. In the staff's view, compliance programs and related policies and procedures are not "set it and forget it" endeavors, and having a process in place to address new compliance risks and challenges is critical to the effectiveness of the compliance programs.