OLIVER WYMAN

TIME TO START AGAIN

PRELIMINARY VIEWS ON REGULATION BEST INTEREST

AUTHORS

Bradley Kellum, Partner

Tammi Ling, Partner

Allen Meyer, Partner

Michael Moloney, Partner

Farooq Sheikh, Principal

EXECUTIVE SUMMARY

For US broker-dealers, the SEC Regulation Best Interest ('Reg BI' or the 'Rule') will require significant effort for compliance by June 30th, 2020. While it preserves the brokerage model in the name of client choice, access and cost considerations, the Rule will nevertheless result in large-scale change. Firms must develop a point of view on client best interest; re-align brokerage advice models, disclosures, supervision and compliance oversight; and overhaul end-to-end technology and operational infrastructures to adapt to the new environment. Firms operating both broker-dealer and advisory models will be forced to choose between a single standard of client care, or separate regimes that each satisfy their 'best interest' obligations with the resultant client confusion and operational complications.

Though the Rule is generally considered less onerous than the now-vacated DOL 'Fiduciary Rule', it is more expansive in breadth (for instance, Reg BI has very significant disclosure requirements). Broker-dealers will need to actively manage the complexity of committing to long-term business model changes while interpreting broad principles-based regulatory requirements. The magnitude of the effort to comply is further exacerbated by the need to involve multiple stakeholders including business leadership, distribution, product, compensation, compliance, technology and operations.

We recommend that broker-dealers begin their Regulation Best Interest readiness programs now, and expect many firms will rely heavily on increased standardization of their advice models, systematic reassessment of their product shelves and potentially redesigned compensation grids to meet the required new standard.

1. INTRODUCTION

Over the past decade, there have been ongoing efforts to enhance the standard of care for retail investors, starting with the 2011 SEC staff study[1], FINRA Rule 2111 (Suitability) and the ultimately-repealed DOL Fiduciary Rule. In the latest development, the Securities and Exchange Commission (SEC) adopted a package of rulemakings[2] on June 5th, 2019, which included the Regulation Best Interest and the Form CRS Relationship Summary:

- **Regulation Best Interest:** Establishes a new "best interest" standard of care for broker-dealers when making a recommendation on any securities or investment strategy for retail customers, including specific obligations around disclosure, care, conflicts of interest and compliance;
- **Form CRS Relationship Summary:** Establishes requirements for the provision of a "relationship summary" form by investment advisers and broker-dealers to retail investors including a broad array of information such as summary of relationships, services, costs, conflicts, standard of conduct, and disciplinary history.

Reg BI will have significant implications for broker-dealers' business models in what is already a rapidly evolving advisory landscape. It will also require a substantial uplift in most firms' supervisory and control structures.

This paper presents our initial perspectives on issues raised by the Rule across advice models, product selection processes, compensation models, supervision and compliance frameworks, and downstream operations and technology infrastructures. Impacted firms should move quickly to conduct a formal diagnostic to identify gaps relative to the Rule's requirements and develop a roadmap for implementation considering the SEC has set a compliance date of June 30th, 2020.

[1] Study on Investment Advisers and Broker-Dealers, as required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Jan 2011

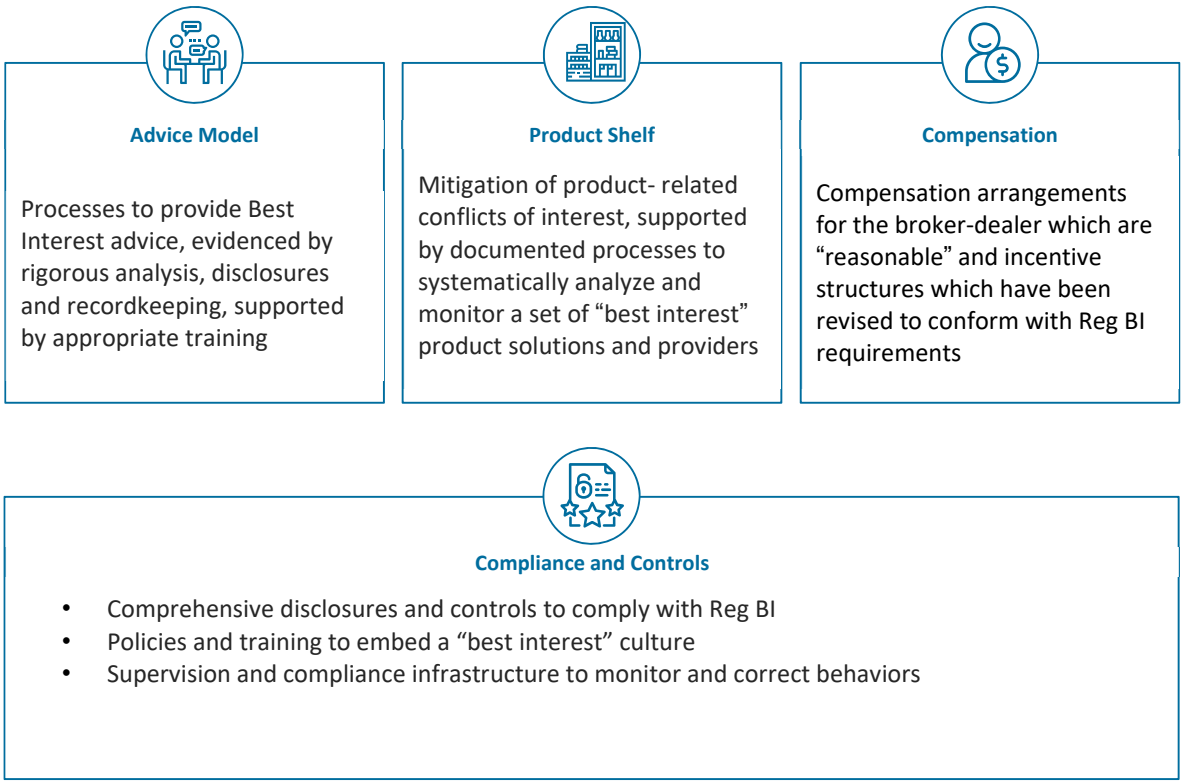
[2] In addition, two separate interpretations under the Investment Advisers Act of 1940 were also included

2. CRITICAL RULE IMPACTS

Despite industry requests, the SEC did not provide prescriptive guidance around many aspects of the final Rule, including the definition of "best interest" or a "bright line" test for compliance. As a result, broker-dealers will need to carefully consider the general principles in the Rule and develop their own firm-specific interpretations. Initial decision-making will then need to be course-corrected as incremental guidance becomes available from the SEC and industry best practices emerge.

Broker-dealers will need to carefully consider how to balance investor choice, competitive differentiation, practical implementation considerations and compliance risk – all of which will need to be supported by a comprehensive implementation, change management and training program. This is a repeat of the process we saw unfolding in the early days of the DOL Fiduciary Rule standard where firms took different positions based on the nature of their business models – decisions were informed by the relative prevalence of commission-based versus managed advice business, the degree of use of proprietary products by registered representatives, differentiation in compensation across products, the degree of individual representative's discretion versus centralization, and the importance of IRA rollovers volumes.

Exhibit 1: Oliver Wyman Impact Framework



Advisory Model

The Duty of Care Obligation articulates a higher standard of care than the existing FINRA suitability standard. Broker-dealers will need to develop a practical interpretation of the best interest advice framework in the context of their respective business models. Examples of the types of questions broker-dealer management teams will need to ask themselves include:

1. How to enhance existing advisory processes so registered representatives have a more holistic understanding of their customer accounts to justify and document "best interests" advice?
2. How to address particular conflicts associated with IRA rollovers given significant differences in retail advisory costs relative to 401(k) plans?
3. How to develop/enhance processes around the determination of whether to put customers in managed account programs or broker-dealer accounts?
4. Should two best interest regimes be maintained for brokerage and managed accounts or consolidated into one common approach?

Since the standard of care is being uplifted, it may also be an appropriate time to consider limiting the selection criteria for registered representatives in brokerage accounts based on client profiles. In its simplest form, firms can develop a set of client personas and needs representative of their client base and then establish recommendation menus for registered representatives from which to make recommendations.

Product Shelf

The Conflict of Interest Obligation requires broker-dealers to mitigate conflicts that might incentivize registered representatives to put their, or the broker-dealer's, interests ahead of the customer's. The Duty of Care Obligation requires the broker-dealer to offer its registered representatives' products that have been subject to a sufficient due diligence review for appropriateness for the firm's customers. And while broker-dealers have long been required to ensure products are suitable for any investor in a general way, they must now think through what it means in the context of specific clients and client situations. Both requirements will impact the product shelf of many firms. The questions referenced below will be critical for the initial diagnostic on the defensibility of the product shelf selection processes and the economic arrangements in place with product vendors.

1. Product shelf construction processes:

- Does the product shelf construction process consider and document the specific needs of the target customers to select product solutions and providers, considering the full range of alternatives available in the market?
- How are specific product conflicts, including conflicts related to proprietary products and active mutual funds (versus ETFs, passives), addressed during the product shelf construction process?
- Is there a formal, rigorous process for new product providers to be inducted to the product shelf which includes a variety of stakeholders (e.g., Compliance)?
- Are there periodic reviews of the products? Are all these processes sufficiently documented?
- Are written policies and procedures detailed and robust?

2. **Economic arrangements with product vendors:**

   The Rule speaks to conscious and unconscious bias in connection with recommendations. This will require broker-dealers to review and mitigate potential conflicts in product platforms (e.g. trading arrangements) and preferred relationships (e.g., with mutual fund families, annuity manufacturers). In addition, while the Rule does not eliminate proprietary products, it will be very difficult to mitigate the conflicts of interest associated with them and demonstrate that a proprietary product is in the best interests of a particular client. At a minimum, broker-dealers will need to subject proprietary products to a very robust review to meet the highest quality standards in comparison to peer products.

Compensation

The Duty of Care Obligation requires that a recommendation is in the best interests of a retail customer based on the investor's profile and the potential risks, rewards and costs associated with the recommendation. The SEC has brought "cost" to the fore as a key factor for best interest when it was not as prominent a factor in the FINRA suitability test.

The Rule does not provide any explicit requirement for brokers to recommend the least expensive or least remunerative option, provided they satisfy their duties of care. Brokers are also not required to find the single best alternative, and costs and compensation arrangements may be outweighed by other factors (e.g., special features). We expect Reg BI will require a comprehensive review of compensation arrangements to address a range of questions, including:

1. How to address challenges related to certain types of product choices with similar features but very different cost profiles (e.g., mutual funds versus ETFs)?
2. How to review compensation arrangements so that absolute compensation levels for products are reasonable?
3. How to mitigate potential conflicts driven by relative compensation differences across the entire product shelf?
4. Lastly, the Rule requires elimination of sales contests, sales quotas, bonuses and non-cash compensation associated with the sale of specific securities in a specified amount of time. This is a meaningful increase over existing FINRA non-cash compensation rules and we expect these restrictions will have significant impacts within certain environments particularly for insurer-owned broker-dealers

In our experience, these conflicts will likely require wholesale changes across existing compensation arrangements similar to the changes contemplated, but not implemented, under the DOL Fiduciary Rule (e.g. modification of existing A shares, addressing 12b-1 fee conflicts, creation of new "no load, no fee, no 12b-1" mutual fund share classes). Firms may choose to leverage a "neutral factors-based" type of approach developed for DOL purposes to support compensation practices.

Compliance and Controls

The Rule places a specific focus on the conflicts that are inherent to the broker-dealer business model and mandates a higher standard of care, requiring enhancements across the supervisory and compliance infrastructure, recordkeeping practices and broker-dealer's regulatory interface with FINRA and the SEC.

The Disclosure and Compliance Obligations will require substantial attention from broker-dealers. Specifically, the Disclosure Obligation requires, prior to or at the time of a recommendation, full and fair disclosure, in writing of all material facts relating to the scope and terms of the relationship. This includes the capacity in which the advice is being given, material fees and costs, and any limitations on products. However, this disclosure need not be individualized and other regulatory documents can be utilized.

At most broker-dealers, the Legal team will be responsible for developing this disclosure and will need to decide whether it should be product-specific or omnibus. Making this disclosure useful to the client and, at the same time, sufficiently comprehensive to avoid risk will be challenging. Broker-dealers should consider this disclosure in conjunction with the design of Form CRS. For these purpose, broker-dealers will need to make important disclosure decisions including:

1. What document(s) are the most appropriate to provide the required disclosures?
2. Whether to leverage existing document(s) or whether new disclosure document(s) are required?
3. What should be the content, tone and language for required disclosures?
4. How will these disclosures be delivered (e.g., electronically) and will customer acknowledgement be required?

The Compliance Obligation principally requires policies and procedures to comply with Reg BI as a whole. The SEC can bring an action against a broker-dealer for inadequate policies and procedures without an underlying violation of the Rule. Accordingly, it will be very important for broker-dealers to conduct a holistic review of their policies and procedures. As referenced above, Reg BI will impact many policies and procedures including those on conflicts of interest, product shelf, registered representative compensation, customer profile information, recommendations and suitability (now “best interests”), disclosure practices, non-cash compensation, type of account selection and supervision. Broker-dealers should begin this exercise by identifying all of the impacted policies and procedures and then develop a deliberate effort to change them as “business decisions” are made on how best to comply with Reg BI.

Reg BI will also have material consequences for supervisory and compliance control processes. The intensity of the change effort will depend on the business decisions that are made in connection with the Rule. For example, if a broker-dealer decides to limit registered representative autonomy to make a recommendation or limit the recommendation opportunities based on customer profiles, then the uplift of supervisory and compliance processes will be lesser in scale than if greater degrees of freedom are maintained. Similarly, if a firm maintains two different compliance regimes for broker-dealer accounts and managed accounts, this will increase the complexity of the Compliance uplift.

As part of Reg BI implementation, broker-dealers will need to consider their supervisory system. Further, broker-dealers will need to determine what monitoring will be necessary with a reasonable cost-benefit focus. Based on the quantitative suitability requirement now applicable even without de facto control over an account, broker-dealers will need to review activity not only on a transactional basis but with respect to a series of transactions. We expect broker-dealers will need to comprehensively address a number of specific supervision and compliance challenges pertaining to Reg BI such as:

1. How to check that the broker-dealer's policies and procedures comply with all requirements of Reg BI?
2. Whether the supervision and compliance systems and tools in place to monitor registered representative recommendation activity are sufficient to comply with the Duty of Care and Conflict of Interest Obligations?
3. How to design a training program that enables the cultural and process changes contemplated by the Rule?

Other Considerations

In addition to the points highlighted above, firms will need to consider the following:

- **Planning for ongoing change:** The Rule will be subject to the robust enforcement and examination regimes of the SEC and FINRA, as well as, arbitration forums which collectively will give Reg BI real bite. We expect that FINRA will make substantial rule changes to align with Reg BI so this is not the end of the rule-making process related to Reg BI.
- **State-level fragmentation and complexity:** The SEC notes that the federal preemption of Regulation Best Interest would be determined in future judicial proceedings, making it difficult to determine what will happen in states that have already, or are planning to propose their own fiduciary standards. This will add an incremental layer of complexity as broker-dealers determine their course of action in these states and assess how to best comply with a complex myriad of federal and state regulatory requirements.
- **Non-registered products:** Broker-dealers will need to decide whether to allow registered representatives to continue to offer non-registered products (e.g. FIAs) and if so, whether to apply the higher standard of conduct for non-registered products.
- **Title changes:** In light of the restriction on the use of the title adviser from Reg BI, non-dually registered firms will, in many cases, need to change their title structures and, for dually registered firms, those registered representatives without an investment adviser registration, will need to change their titles. The title changes necessary will create a substantial administrative burden and cost.

KEY ASPECTS OF THE RULE- SUMMARY

Reg BI requires a "best interest" standard of conduct for broker-dealers when making recommendations on any security or investment strategy to a retail customer. The scope of the Rule covers all registered products across qualified and non-qualified accounts[3]. Specifically, broker-dealers will have to comply with four obligations[4]:

- **Disclosure Obligation:** Brokers must reasonably disclose all material facts relating to the scope and terms of the relationship and all material facts relating to conflicts of interest associated with the recommendation to retail customers in writing at or before the time of a recommendation. In this context, conflict of interest means an interest that might incline a broker-dealer to consciously or unconsciously make a recommendation that is not disinterested.
- **Care Obligation:** Brokers must act with diligence, care, and skill to understand the risks, rewards and costs associated with the recommendation, have a reasonable basis to believe the recommendation, or the series of recommendations, are made in the best interest of the retail customer. This requires the broker-dealer to understand the potential risks, rewards and costs associated with the recommendation
- **Conflict of Interest Obligation:** Brokers must establish, maintain, and enforce written policies and procedures to identify, disclose, and mitigate/eliminate material conflicts of interest. A broker-dealer must identify and mitigate any conflicts of interest associated with recommendations that create an incentive for its financial professionals to place their interest or the interest of the broker-dealer ahead of the retail customer's interest.
- **Compliance Obligation:** Brokers must establish, maintain and enforce written policies and procedures designed to comply with Reg BI as a whole.

Additionally, the Rule restricts firms solely registered as broker-dealers from using the term "adviser" or "advisor" when communicating with retail investors. These firms must also prominently disclose registration with the SEC as a broker-dealer in print or electronic retail investor communications. The title reform could have a large impact for non-dually registered advisors, both from an operational and an emotional perspective, as most broker-dealers currently have the word "adviser" or "advisor" in their title.

[3] Unlike the now vacated Department of Labor rule, which only covered qualified retirement accounts

[4] These obligations are not meant to amend or eliminate broker-dealer obligations under SEC or FINRA's regulations

Contact information:

Bradley Kellum
Partner, Oliver Wyman
bradley.kellum@oliverwyman.com

Tammi Ling
Partner, Oliver Wyman
tammi.ling@oliverwyman.com

Allen Meyer
Partner, Oliver Wyman
allen.meyer@oliverwyman.com

Michael Moloney
Partner, Oliver Wyman
michael.moloney@oliverwyman.com

Farooq Sheikh
Principal, Oliver Wyman
farooq.sheikh@oliverwyman.com

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting. With offices in 60 cities across 29 countries, Oliver Wyman combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation. The firm has more than 5,000 professionals around the world who work with clients to optimize their business, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is a wholly owned subsidiary of Marsh & McLennan Companies [NYSE: MMC].

For more information, visit www.oliverwyman.com. Follow Oliver Wyman on Twitter @OliverWyman

www.oliverwyman.com