

Switching hats in a post-regulation best interest world

With the adoption of Regulation Best Interest (Reg BI), the US Securities and Exchange Commission (SEC) is imposing an enhanced standard of conduct on broker-dealers and their associated persons when making recommendations to retail customers. However, Reg BI differs from the standard of conduct applicable to investment advisers and their supervised persons when providing advisory services to clients. Reg BI also differs from the standards of conduct applicable to financial professionals when they recommend non-securities products, such as insurance or banking products, or when they hold designations such as Certified Financial Planner (CFP). This paper addresses the impact of Reg BI on financial professionals who are registered representatives and (i) supervised persons of an investment adviser or (ii) also offer non-securities products and services (dually registered financial professionals). This paper also discusses certain best practices that firms may wish to consider in order to minimize the risks presented when dually registered financial professionals provide recommendations to retail customers in various capacities.

A. The Many Hats of Financial Professionals

Approximately 25% of registered individuals at broker-dealers or investment advisers are dually registered financial professionals who can provide both brokerage and advisory products and services.¹ And while only about 50% of registered representatives are dually registered as investment adviser representatives, approximately 87% of investment adviser representatives are dually registered as registered representatives.² When adopting Reg BI, the SEC acknowledged that a financial professional who is associated with a broker-dealer may also offer a variety of non-securities products and services to meet the needs of customers.³

For example, in addition to brokerage and advisory services, a financial professional may also offer banking

or insurance products and services.⁴ As a result, many financial professionals wear more than one “hat” while servicing a customer, and may be required to comply with conflicting standards of conduct based on the hat he or she wears when recommending a product or service. It is imperative for broker-dealers and their financial professionals who offer a variety of securities and/or non-securities products and services to be mindful of the capacity in which the financial professional is acting when providing recommendations or investment advice, and the applicable standard of conduct, in order to avoid running afoul of the federal securities laws and regulations, state securities laws and regulations, FINRA rules and the rules adopted by financial professional certification organizations.

¹ Form CRS Relationship Summary; Amendments to Form ADV, 84 Fed. Reg. 33492, 33570 (July 12, 2019) (Form CRS Release).

² Form CRS Release at 33571.

³ Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318, 33406, n. 891 (July 12, 2019) (Reg BI Release).

⁴ Reg BI Release at n. 848.



B. Application of Reg BI to Non-Securities Recommendations and Other Activities

Reg BI requires a broker-dealer (or its associated person), when recommending a securities transaction or investment strategy involving securities to a retail customer, to act in the best interest of the customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer or associated person ahead of the interest of the retail customer. Reg BI expressly provides that a recommendation of an investment strategy involving securities includes recommendations of an account type. According to the Reg BI adopting release, an investment strategy involving securities also includes rollovers or transfers of assets and implicit hold recommendations resulting from agreed-upon account monitoring. A recommendation that a retail customer roll over or transfer assets to an IRA held at the broker-dealer, or open an IRA or another securities account with a broker-dealer, presumes that the recommendation would involve transactions in securities, even if the rollover or account recommendation does not result in transactions or transaction-based compensation.⁵ If a dually registered financial professional is acting as a registered representative of a broker-dealer, he or she will need to take into consideration all account types that he or she can offer when recommending an account for a retail customer.

An investment adviser's fiduciary duty generally is broader than the requirements imposed on broker-dealers by Reg BI. An adviser's fiduciary duty applies to the entire relationship between the adviser and its clients, including

advice provided on securities and non-securities. An entity that is both an investment adviser and a broker-dealer (dual registrant) is an investment adviser solely with respect to those accounts for which it provides investment advice that subjects it to the Advisers Act.⁶ As a result, Reg BI would not apply to investment advice provided to a client by a dual registrant when acting as an investment adviser even if: (i) the client also has a brokerage relationship with the dual registrant; (ii) the dual registrant executes the securities transaction for the retail customer in its capacity as a broker-dealer; and (iii) the dual registrant receives transaction-based compensation for executing the transaction.⁷ The same concept also applies when a broker-dealer is engaged in providing other financial services (for example, as a bank, a commodity trading advisor or a future commission merchant).⁸ Given the foregoing, determining the capacity in which advice is provided is critical to determining what standard of conduct applies when a dual registrant (and its dually registered financial professionals) provides securities advice to retail customers.

For example, bank employees may also be associated persons of a broker-dealer and may offer the bank's customers a range of financial services through bank networking arrangements. Financial professionals who are employees of a bank, and who are registered with a broker-dealer to effect securities transactions should be aware that Reg BI may apply to a securities recommendation to a retail customer. Similarly, insurance producers are often dually registered to effect transactions in securities through a broker-dealer and may, for instance, recommend the sale of securities in a brokerage account and using the proceeds from the sale to purchase a fixed insurance product. Whether the financial professional is acting in his or her capacity as a registered representative or insurance producer (or both) would be relevant to determining whether Reg BI applies to a securities recommendation to a retail customer.

Moreover, CFP professionals often are dually registered to effect transactions in securities through a broker-dealer, and may also be supervised persons of an investment adviser. Because the CFP Board certifies individuals and

⁵ Reg BI Release at n. 194.

⁶ Reg BI Release at 33345.

⁷ Reg BI Release at 33345, n. 274.

⁸ Reg BI Release at n. 269.

⁹ Reg BI Release at 33346.

not firms, CFP professionals should understand when their activities would require compliance with the CFP Standards of Conduct. However, both CFP professionals and their firms should understand when a CFP professional's activities will constitute brokerage activity and will require compliance with Reg BI. In this respect, when a CFP professional provides "financial advice" under the CFP Standards of Conduct, the CFP professional and his or her broker-dealer must consider whether he or she is acting as an associated person of the broker-dealer and is subject to Reg BI.

Determining the capacity in which a dually registered financial professional makes a recommendation for purposes of Reg BI is a facts and circumstances analysis, with no one factor being conclusive. The SEC considers, among other factors: (i) the type of account; (ii) how the account is described; (iii) the type of compensation; and (iv) the extent to which the financial professional made clear to the customer the capacity in which he or she was acting.⁹

C. Comparing Reg BI to Other Financial Professional Standards of Conduct

Dually registered financial professionals must be attentive to activities that trigger the need to comply with multiple standards of conduct. In this respect, the triggering events for complying with a broker-dealer's best interest obligation under Reg BI, an adviser's fiduciary duty under the Advisers Act and a CFP professional's fiduciary duty under the CFP Standards of Conduct are different:

Broker-Dealer	Standard: Best Interest; cannot modify scope of best interest duty via customer consent Trigger: Making recommendations of any securities transaction or investment strategy to a retail customer
Investment Adviser	Standard: Fiduciary; 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 Trigger: At the formation of an investment advisory relationship
CFP Professional	Standard: Fiduciary; responsibilities and the scope and nature of services provided can be altered but the fiduciary duty cannot be waived or changed by clients Trigger: Providing "financial advice" (including financial planning services)

While a dually registered financial professional at times may intend to act only in a brokerage capacity, there may be times that his or her conduct will also trigger the need to comply with the Advisers Act or the CFP Standards of Conduct. For this reason, dually registered financial professionals and their firms should take steps to mitigate the risks created when switching hats.

D. Mitigating Risk When Switching Hats

Prior to Reg BI's enforcement date of June 30, 2020, broker-dealers should consider policies, procedures and controls to mitigate the risks created when dually registered financial professionals switch hats and change the capacity in which they are acting. Such policies, procedures and controls may include: (i) proper disclosure and consent to capacity; (ii) maintaining, records of recommendations and the basis for such recommendations; and (iii) proper training, supervision and oversight of dually registered financial professionals' activities. Each of these is discussed in more detail below.

Disclosing capacity. Under Reg BI, a broker-dealer is required, prior to or at the time of a recommendation, to provide a retail customer, in writing, full and fair disclosure of all material facts relating to the scope and terms of the relationship with the retail customer, including that the broker-dealer or its associated person is acting as a broker-dealer or an associated person of a broker-dealer with respect to the recommendation. Associated persons must disclose whether they are acting as an associated person of a broker-dealer to satisfy the Disclosure Obligation of Reg BI. As an example, the SEC provides in the Reg BI Release that a broker-dealer may disclose that: "All recommendations will be made in a broker-dealer capacity unless otherwise expressly stated at the time of the recommendation; any such statement will be made orally," in which case no further oral or written disclosure would be required until a recommendation is made in a capacity other than as a broker-dealer. The SEC also notes that a broker-dealer may disclose that: "All recommendations regarding your brokerage account will be made in a broker-dealer capacity, and all recommendations regarding your advisory account will be in an advisory capacity. When we make a recommendation to you, we will expressly tell you orally which account we are discussing," in which case no further disclosure of capacity would be necessary.

Obtaining consent. As noted above, Reg BI requires a broker-dealer to provide full and fair disclosure of all material facts relating to the scope and terms of the relationship with the retail customer. The purpose of this disclosure is for a retail customer to be able to make an informed decision regarding the recommendation (i.e., whether to accept or reject the recommendation). Assuming the retail customer has been provided with full and fair disclosure, the retail customer will be considered to have provided informed consent by affirmatively accepting a recommendation. To strengthen compliance with Reg BI and other regulations, broker-dealers may wish to consider adopting policies and procedures that require dually registered financial professionals to provide written disclosure and obtain consent to the change in the scope and terms of their relationship with customers when the financial professionals switch hats. Such consent would serve to protect broker-dealers and their associated persons from risks associated with hat switching by ensuring that customers understand precisely when their dually registered financial professionals change the capacity in which they act and when the obligations of Reg BI attach.


Maintaining records. Reg BI does not require broker-dealers to (i) create or maintain records to evidence = best interest determinations on a recommendation-by-recommendation basis, (ii) provide information to retail customers relating to the basis for each particular recommendation or (iii) maintain records comparing potential investments with one another so long as they are able to demonstrate that each individual recommendation actually made to a customer meets the requirements of Reg BI on its own. However, in order to comply with Reg BI, “broker-dealers should be able to explain in broad terms the process by which the firm determines what recommendations are in its customers’ best interests, and similarly to explain how that process was applied to any particular recommendation to a retail customer.” In addition, “firms may wish to adequately document an evaluation of a recommendation and the basis for that recommendation in particular contexts, such as the recommendation of a complex product, or where a recommendation may seem inconsistent with a retail customer’s investment objectives on its face.” As a best practice, firms should consider adopting policies and procedures to create and maintain records to evidence

compliance with the applicable standard of conduct regardless of capacity. In doing so, firms may decrease the risk that a dually registered financial professional will not comply with the appropriate standard of conduct when making a recommendation.

Training associated persons. Broker-dealers may wish to consider training for financial professionals who are dually registered. Because capacity is a question of facts and circumstances, it is critical for a financial professional who is dually registered to be able to determine the standard of conduct he or she must comply with when providing recommendations to customers. Firms may wish to evaluate their registered representatives’ ability to understand and disclose the capacity in which they are acting when switching hats and making recommendations to customers. In doing so, firms may wish to evaluate the context in which such recommendations are provided and whether it is possible to separate the registered representatives’ brokerage recommendations from other services being provided to customers. Firms may also wish to test whether their disclosures to retail customers are effective in conveying the change and import of their registered representatives’ change in capacity. Indeed, both the SEC and state securities regulators have in the past questioned whether such disclosures are effective when there is ongoing hat switching, particularly when there is an evolving set of different (for example, brokerage, advisory, insurance, banking) services provided at various points in time. Broker-dealers may also wish to train other employees, such as supervisors, on how to supervise registered representatives who switch hats with customers on a regular basis.

Supervising associated persons. Dually registered firms should consider developing supervisory procedures that are reasonably designed to ensure compliance with Reg BI when dually registered financial professionals switch hats





with customers. This may involve, for instance, generating and reviewing exception reports that identify transactions and activities that fall outside firm-specified parameters (for example, if a registered representative has a certain percentage of customer relationships that involve switching hats (within a certain period of time or at particular periods of time, such as at the end of a quarter in order to boost the number of relationships with clients) or multiple hat switches with the same client (within a certain period of time). Firms may also wish to analyze the positions held by customers of registered representatives who switch hats to look for aberrations or other red flags (such as “double dipping,” over-concentration or duplicative positions purchased across investment advisory, brokerage and/or other (for example, insurance) accounts. Supervisors of registered representatives who switch hats on a regular basis may wish to inquire as to whether customers of such registered representatives have higher rates of complaints, unusual trading patterns, redeeming securities soon after purchase, and/or fees and charges.

E. Conclusion

Effectively switching hats when a dually registered financial professional provides advice in various capacities can be challenging. It is imperative that the financial professional effectively and timely communicate the change in capacity in which he or she is acting so that customers understand that such a change is occurring and the import of such a change on their relationship with their financial professional and the responsibilities they are owed. Firms may wish to implement internal controls and procedures to ensure that such disclosures are provided and that such changes in the capacity in which their dually registered financial professionals act do not result in the financial or other interests of the broker-dealer or financial professional being put ahead of the interests of their retail customers.

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