

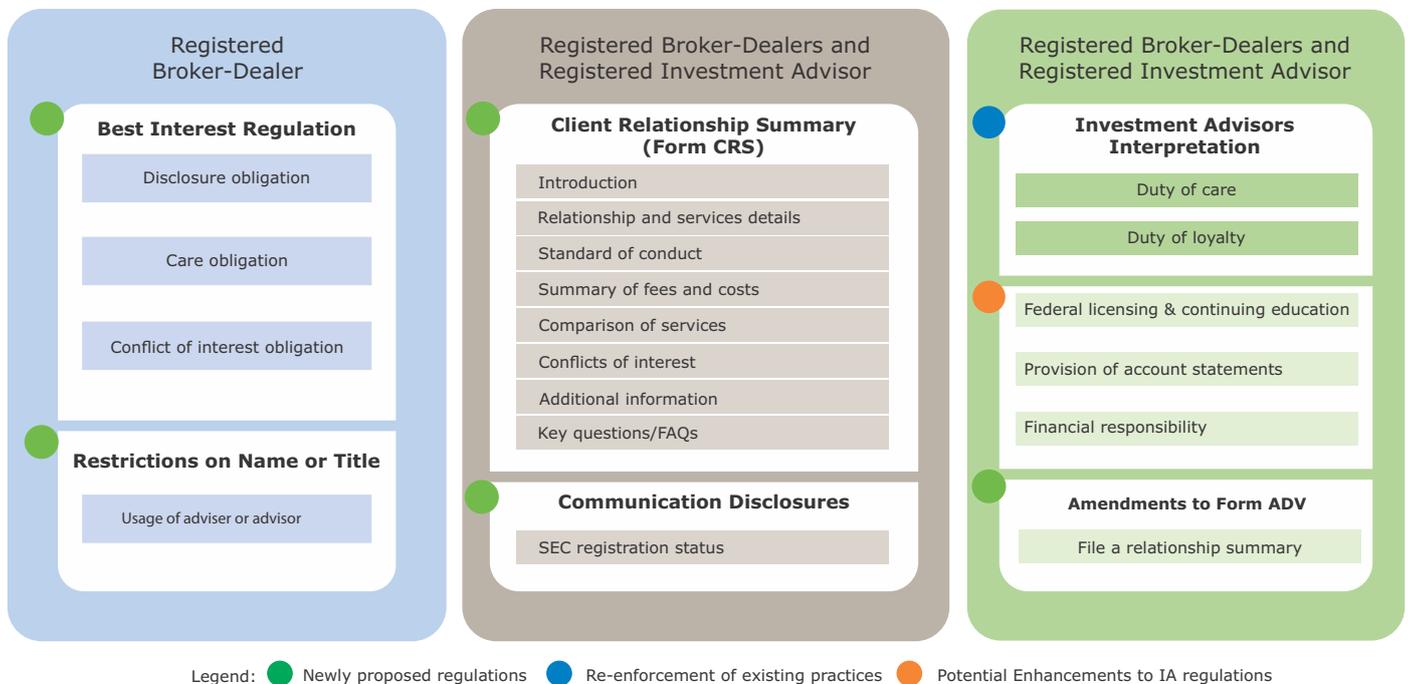
# The SEC Standards: Raising the Conduct Bar for Investment Professionals

## Abstract

The aftermath of the decade old financial crisis has put consumer protection firmly on the regulatory agenda. With the objective of increasing retail investor protection and empowering them to take well-informed investment decisions, the US Securities and Exchange Commission (SEC) proposed new standards of conduct for investment professionals in April 2018. The regulation also seeks to raise awareness among retail investors, ensure access to a variety of investment offerings, and clarify the relationship between investors and their firms. This paper provides insights on how the SEC's proposed regulation will affect investment firms and the approach they must adopt to embrace the new standards while maximizing client value.

## The Regulation at a Glance

Typically, retail investors seek investment advice from either a broker-dealer or an investment advisor. However, quite often, they are not aware of the subtle differences between these two entities in terms of compensation structure, conflict of interest, disclosures, and other regulatory obligations. To safeguard the interest of retail investors and bring in more transparency, the SEC has proposed new standards of conduct for investment professionals (see Figure 1). The SEC has invited the public to share its concerns, which will be reviewed and addressed before the final regulation and the implementation schedule are published.



**Figure 1: SEC’s Proposed Standards of Conduct for Investment Professionals**

In brief, the broker-dealers will be required to disclose material facts associated with investment recommendations, act in the best interest of their clients, eliminate and disclose conflicts of interest, and avoid usage of certain titles unless authorized by the commission (see Figure 1). Both the investment advisors and broker-dealers will be required to provide a relationship summary to the investor. The goal is to subject investment professionals to a standard that addresses reasonable investor expectations around fees and charges, commission, and conflicts of interest irrespective of whether investors engage

with broker-dealers or investment advisors.

## Understanding the Impact

Given the scope of the proposed regulation, consequences will vary for individual firms based on multiple dimensions like business and operating models, client segment, product and service offerings, registration status, and so on. Let us examine the impact of some key aspects of the regulation on broker-dealers and investment advisors.

### **Business impact**

As an outcome of the best interest regulation, registered broker-dealer firms will have to judiciously identify and review material conflicts of interest associated with the recommendations made to retail investors and financial incentives received. In addition, broker-dealers will have to further rationalize their offerings to suit different client segments, and in particular, review the proprietary products, affiliated products, and products for which they receive third-party payments as part of revenue sharing arrangements. Firms will need to adopt a holistic product rationalization strategy that includes identification of conflicts of interest and policies to either manage disclosures or discontinue such products in the interest of meeting regulatory obligations. Registered investment advisors will have to monitor and identify new obligations that may result from the SEC's deliberations on federal licensing, accounting obligations, and financial responsibility and proactively initiate suitable actions.

### **Operational impact**

The SEC Standards require broker-dealers to act in the best interest of retail investors while making recommendations. This will require broker-dealers to prioritize investor interest above their own financial benefit. Achieving compliance with the best interest regulation will require changes to firms' operational procedures. The operational impact will revolve around three specific obligations: the disclosure obligation, the care obligation, and the conflict of interest obligation.

**Disclosure obligation:** Broker-dealers will have to establish mechanisms to disclose the identified material conflicts of interest. They must be sensitive in communicating the disclosures to customers, especially for products that involve

higher cost or risk to investors or result in higher compensation or commission to firms. In addition, broker-dealer firms must initiate steps to restrict the usage of titles such as 'adviser' or 'advisor' while communicating with investors, unless the firm is a registered investment advisor. Both investment advisors and broker-dealers will also be required to disclose their SEC registration status.

**Care obligation:** To comply with the care obligation, broker-dealer firms will need to increase investment in the research and analysis function to understand the potential risk and reward associated with the recommendation and ensure that it is in the best interest of the retail investor segment. The complexity and risks associated with the recommended security or investment strategy will depend on multiple factors such as liquidity, volatility, and shifts in market and economic conditions. Broker-dealers will have to analyze individual customers' investment profile and ensure that the recommendation matches a specific client's context by evaluating multiple dimensions such as the investor's age, other investments, financial situation, tax status, investment goals, experience, time horizon, liquidity needs, and risk tolerance and so on.

**Conflict of interest obligation:** Broker-dealers must adopt appropriate policies and procedures to identify, disclose and mitigate, or eliminate conflicts of interest. They must define their mitigation strategies taking into account factors like the size of the firm, retail customer base, the potential for compensation conflict, and the complexity of the product, and so on. In cases where conflicts cannot be eliminated, firms must establish mechanisms to ensure complete disclosure.

### Form CRS

Investment advisor and broker-dealer firms will need to establish robust client communication and reporting mechanisms or suitably modify existing systems and enhance the underlying IT infrastructure to adhere with the client relationship summary (Form CRS) provision. Table 1 shows the differences in Form CRS for investment advisor firms and broker-dealers.

Type of firm	Client Relationship Summary	Business Event	Implication
Registered Investment Advisor	Form ADV	<ul style="list-style-type: none"> <li>When firms enter into investment advisory agreements with investors</li> <li>When a material change occurs in the existing relationship summary</li> </ul>	<ul style="list-style-type: none"> <li>Amend the current Form ADV by adding Form CRS</li> <li>Deliver Form ADV to retail investors and upload it on SEC's Investment Adviser Registration Depository (IARD)</li> </ul>
Registered Broker-Dealer	Form CRS	<ul style="list-style-type: none"> <li>When retail investors first engage broker-dealers' services</li> <li>When there is material change in the existing relationship summary</li> </ul>	<ul style="list-style-type: none"> <li>Deliver Form CRS to retail investors</li> <li>Upload Form CRS on SEC's Electronic Data Gathering, Analysis and Retrieval System (EDGAR)</li> </ul>

\* Dual registered firms should file on both IARD and EDGAR systems

**Table 1: Differences in Client Relationship Summary for Investment Advisors and Broker-dealers**

### Staying Ahead of the Curve

Given the gravity of the proposed regulation, broker-dealer and investment advisor firms across the US have been keenly following the rule-making process. Though the proposed regulation is yet to become a law, impacted firms are looking at redefining their internal compliance programs. Although, individual program strategies will vary based on business footprint and strategic priorities, we recommend that firms consider a few key dimensions while designing compliance strategies:

#### Training to staff

Staff will need to be educated on the proposed regulation and equipped with the required tools to perform their activities with ease. This will help meet clients' needs keeping in mind the best interest provision thus enhancing customer satisfaction.

#### Application enhancements

Firms must perform a detailed impact assessment and gap analysis to identify the IT systems and processes that will need to be enhanced, and define an implementation strategy to carry out the enhancements. Broadly, meeting the Form CRS and associated disclosure obligations will dictate changes to account opening and client-onboarding processes, advisory channels, and client communication applications. Complying with the care obligation will mandate changes to investment recommendation, product suitability, market research, and risk



analytics applications. In addition, new policies and procedures will need to be established to manage conflicts of interest, which in turn will affect several applications.

### **Digital enhancements**

Firms must make appropriate changes to the processes that support investor communication and information sharing to comply with the enhanced disclosure obligations. In addition, investors are likely to need help in understanding the elements of the relationship summary document. Employing an intelligent virtual assistant or chatbot can help to resolve client queries round the clock, leaving the staff to focus on core business activities. Setting up an automatically accessible centralized repository with all the policies and procedures related to the SEC Standards will go a long way in empowering the staff to drive compliance with the regulation. Similarly, firms must deploy an artificial intelligence (AI) powered recommendation engine to process large volumes of market data and generate unbiased investment recommendations. Firms must ensure that such recommendations meet the SEC Standards' best interest provision, and clients' investment goals and risk profile thereby enabling personalization at scale and driving exponential value for clients as well as firms.

## **The Way Forward**

Achieving timely compliance will demand significant reconfiguration of underlying IT systems and processes. Firms, however, are likely to be constrained by lack of in-house technology expertise and skilled resources required to build new solutions and upgrade the IT infrastructure. Seamless and trouble-free implementation may require firms to tie up with the right vendor post a detailed market analysis and evaluation. Collaborating with the right service provider can quickly deliver value by helping firms to draw up a strategy spanning impact assessment, gap analysis, system integration, and quality assurance as well as an implementation roadmap for compliance.

### About The Author

Kuldeep Shrimali

Kuldeep Shrimali is a Senior Domain Consultant with the Capital Markets group of TCS' Banking, Financial Services, and Insurance (BFSI) business unit. He has over 17 years of consulting experience in the capital markets space. Shrimali has worked with leading global financial firms across geographies and successfully executed several strategic technology transformation programs in the areas of wealth management and capital markets.

### Contact

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