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The Unintended Consequences of Regulation BI

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November 24, 2020

The introduction of Regulation Best Interest (Reg BI) by the SEC has major implications, both good and bad, for registered investment advisors (RIAs) and broker-dealers (BDs). Affecting both parties, the goal is to develop an overall understanding and initiative to provide recommendations in the best interest of clients. Here we will discuss the intended consequences and the possible unintended consequences which may, in some ways, actually adversely affect the end client.

Overview of Reg BI

According to FINRA, the SEC's Regulation Best Interest (Reg BI) "establishes a *best interest* standard of conduct for BDs and associated persons when they make a recommendation to a retail customer of any securities transactions or investment strategy involving securities, including recommendations of types of accounts."¹ The primary change under Reg BI is that the SEC now requires BDs and RIAs to fill out a "Form CRS" containing an obligation to explain the nature of their relationship and services, fees and costs, and their conflicts of interest and standard of conduct.

¹ <https://www.finra.org/rules-guidance/key-topics/regulation-best-interest>

With that said, state regulators will be monitoring the adjustments made by firms with respect to the requirements set out under Reg BI.

In summary, Reg BI has four main mandated components that BDs and SEC registered RIAs must comply with, which include²:

- Introduction
- Relationship and services
- Fees, costs, conflicts and standard conduct
- Disciplinary history

Benefits of Reg BI for Retail Investors

The major benefit for retail investors under Reg BI is the fact that it goes the extra mile in an attempt to protect clients by requiring disclosure and aims to ensure a product is really in their best interest.

In terms of conflicts of interest, a 2019 survey showed that “41% of firms had no policies or procedures, 70% had no internal enforcement committees or officers and 76% didn’t have any “conflict registers” identifying them in detail.”³

However, Andrea Seidt, chair of a Reg BI implementation committee mentioned that it “will likely cause some BDs to stop selling the more complex products”⁴, which can actually be seen as a major downside of Reg BI. More complex products are not for everyone, but in reality, they can be of great value to many clients.

Shortfalls of Reg BI for RIAs and BDs

Although Reg BI was primarily implemented to raise the standards of conduct for BDs, there may be subsequent shortfalls that lead to a reduction in quality product offerings due to the series of regulatory hoops that BDs must jump through. **Have the regulators shot themselves in the foot by actually making it harder for advisors to offer access to quality alternative investments?**

For example, BDs and RIAs are now required by the SEC to put together two-page relationship summaries, called a Form CRS, for every retail client. You can imagine how much time is spent on regulatory issues for BDs and RIAs who are already wearing multiple hats trying to best serve their clients. In fact, it is estimated that “**each advisor will spend an average of 23.77 hours and over \$6,000 to build the form**”⁵ for their firm. So now the question is, could the burdensome paperwork of Form CRS, primarily the requirement of providing fees, costs, and product structures, lead to simpler “plain vanilla” investment strategies and product offerings?

² <https://www.advisorperspectives.com/articles/2020/05/18/what-independent-broker-dealers-need-to-know-and-do-for-reg-bi>

³ <https://www.financial-planning.com/news/nasaa-describes-exam-priorities-under-sec-reg-bi>

⁴ <https://www.financial-planning.com/news/nasaa-describes-exam-priorities-under-sec-reg-bi>

⁵ <https://rixtrema.com/blog/form-crs-is-the-biggest-reg-bi-compliance-hurdle-for-rials/>



This is especially worrisome as we see the historical 60/40 portfolio structure struggle even further due to low bond yields and diversification issues, while the alternative investment space gains traction. In an ideal world, we should be encouraging the use of high-quality alternative investments that can add significant value to an individual's portfolio and lower equity market correlation. That is truly in their best interest. But in reality, Reg BI might just encourage advisors to do the opposite – stray away from alternative investments in an attempt to comply rather than create opportunity. This will likely hurt the smaller RIAs and BDs more than others because of their inability to automate regulatory processes under Form CRS and the additional time burden this places on them.

David Wegner, Esq. of The Bowman Law Firm, LLC stated: *“Reasonable regulation has its place in the alternative investment arena. At times, however, new regulations do have unintended consequences. Regulation BI was designed to enhance clarity and disclosures to investors in the financial services space, though its implementation has required significant expenditure of time and effort. However, if a broker-dealer or investment advisor was not already taking steps to establish the best interests of their clients – being clear on relationships and fees; disclosing their potential and actual conflicts of interest; and living by a steadfast standard of conduct – a form alone may not change that.”*

As an advocate of the alternative investment industry, no one, including Bowman Law, wants to see the space suffer nor contract due to the unintended consequences of any regulation. Planning and strategic partnerships in the industry will be key in easing the burden anticipated under Reg BI.

Do alternative investment product providers have to do more to support RIAs or risk losing some of their selling group?

Aside from affecting BDs and investment advisors, Reg BI could have a profound impact on alternative investment product providers. If Reg BI pushes advisors away from more complex product offerings, it may encourage more advisors to continue toward plain vanilla investment strategies, in which product providers in the alternative investment space will truly feel the effects. With that said, product providers may have to find ways to support RIAs and BDs by handling their Reg BI burdens in hopes that it allows them better access to, and opportunity for alternative investment offerings. Alternative investment product providers should ask themselves two questions:

- Are we prepared?
- How can we better support RIAs and BDs?

This may prove difficult for boutique alternative investment providers who are limited by having few team members. However, larger firms may consider developing small teams to help solve this potential problem stemming from Reg BI. **At Hillson Consulting, we believe product providers in the alternatives space could lose up to 20% of their wholesale channels if the workload burden and risk proves as cumbersome in practice as anticipated.** Therefore, the responsibility will be on **YOU** as a product provider. You must do the heavy lifting for the RIAs and BDs and take the extra burden of Reg BI off their plate. Providing support may be your only option.



Educational Requirements of Reg BI

Some training providers are trying to stay ahead of this curve in providing educational support around some of the more complex product verticals. This ranges from a refresher course in certain types of investment, to a holistic market view around that product, incorporating some provider structure and fee comparisons. It is yet to be seen whether the regulators give due credit for advisors who *sharpen the axe*, but there is never any harm in improving our knowledge or hearing other viewpoints on the marketplace.

Hillson Consulting is working diligently on 3 fronts to provide support:

- 1) An independent party to help product providers provide the necessary support to RIAs.
- 2) Support to RIAs doing their due diligence on the market and comparing products and fee structure.
- 3) Working with an educational partner, so that advisors can get a third-party certificate of completion for further study in that product vertical.

Although Regulation Best Interest is in its early days, the consensus of interpretation suggests that this will be more cumbersome for BDs, but still a burden for RIAs. Arthur Loyd, Esq. from The Bowman Law Firm, LLC agrees: *“It is particularly onerous to the BDs as they have historically been held to the suitability standard while RIAs have a fiduciary duty, arguably a higher threshold than the “best interest” requirement. Implementation of processes and procedures for compliance with the Regulation will be felt by all parties on the front end. Appropriate disclosures by, and due diligence and analysis of, product sponsors and issuers will help ease that burden for BDs and RIAs.”*

Understandably, there have been numerous conversations about how the SEC will be monitoring this new mandate. We may need to wait for the ensuing “case law” to see just how the regulators interpret this in practice and enforce. Furthermore, under President-elect Joe Biden, we may see a more aggressive interpretation of Reg BI as well as stricter enforcement. In fact, SEC Chairman Jay Clayton noted that they are hiring additional examiners to increase their focus and efforts with regard to Reg BI compliance.⁶

However this unfolds, it is never contrary to client interests for product providers to educate client facing fiduciaries, nor for advisors to gain a better understanding of the marketplace and what is available. Even more importantly, anything that encourages advisors to gain more clarity and understanding surrounding product offerings, especially in the alternative investment space, is a step in the right direction.

⁶ <https://www.thinkadvisor.com/2020/11/10/sec-continued-with-vigor-despite-pandemic-clayton/>



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