Credit Union Times

An ALM Publication

JANUARY 8, 2020 | CUTIMES.COM

GUEST OPINION

Your Investment Workforce Will Be Fiduciaries in 2020

As credit unions continue to expand into the investment brokerage business with onsite Certified Financial Planners (CFPs) and FINRA Series 7 registered representatives (RRs) to serve the investment and financial planning needs of their members, it is essential that they recognize and plan for the impending changes that will recast those credit union employees as fiduciaries.

It has long been the goal of securities regulators and industry watchdogs to raise industry standards above the investment suitability standard currently applicable to RRs. The Department of Labor attempted to accomplish this in 2016 with the adoption of the Fiduciary Rule. That attempt was rejected by the Fifth Circuit Court of Appeals in 2017 and then abandoned by the current administration.

Now the Securities and Exchange Commission and Certified Financial Planner Board of Standards have stepped in. Soon to be gone are the days when recommendations made by RRs must simply be "suitable." A new era is upon us in which, under many circumstances, RRs are required to act in the "best interest" of retail customers. On June 30, 2020, SEC Regulation Best Interest (Reg. BI) goes into effect, which will require all RRs to act in their customers' best interest thereby effectively creating a fiduciary-like standard for all RRs, whether they are employed by broker-dealers (B-Ds), banks, insurance companies or credit unions. The new SEC standard draws from key principles underlying fiduciary obligations that apply to investment advisers under the Investment Advisers Act of 1940. Also on June 30, the CFP board will begin enforcing its new Code of Ethics and Standards of Conduct (the CFP Standards) for the more than 82,000 CFPs across the country. The new CFP Standards significantly expand the fiduciary duties that credit union CFPs will owe to the members they serve.

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Regulation Best Interest

Reg. B.I., which applies to the independent B-Ds with whom credit unions often contract for their brokerage force, can best be thought of in two steps. First, B-Ds and RRs have a "General Obligation." Second, in order to comply with the General

Obligation, they must comply with four component obligations: The Disclosure Obligation, Care Obligation, Conflict of Interest Obligation and Compliance Obligation. Stated differently, the four component obligations explain what B-Ds and RRs must do to comply with the General Obligation.

The General Obligation provides that when an RR makes a recommendation on any investment strategy or securities transaction, the RR must act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the RR ahead of the retail customer. This does not mean that all recommendations must be free from a conflict of interest. Rather, B-Ds and RRs must take steps to eliminate, or in some cases, reduce the effect of the conflict. A retail customer is defined to mean a natural person, or the legal representative of a natural person, who receives the recommendation and uses it primarily for personal, family or household purposes.

The Disclosure Obligation requires the RR to make a disclosure in writing at the time of the recommendation. The written disclosure must include all material facts relating to the scope and term of the relationship with the retail customer. It includes a disclosure that a credit union's B-D is acting as a broker-dealer with respect to the recommendation, the material fees and costs that will apply, and any material limitations on the strategy or transaction being recommended. Examples of material facts that must be disclosed are how the RR is compensated if the recommendation is followed.

The Care Obligation requires both the RR and the B-D, when making the recommendation, to exercise reasonable diligence, care and skill. This means the RR must understand the potential risks, rewards and costs associated with the recommendation and have a reasonable basis to believe the recommendation is in the retail customer's best interest. In forming the opinion that the recommendation is reasonably in the retail customer's best interest, the RR must consider the customer's investment profile and the potential risks, and it must not place his, her or the B-D's financial or other interest ahead of the customer.

The Conflict of Interest Obligation requires B-Ds to establish, maintain and enforce written policies and procedures that are reasonably designed to identify and disclose conflicts, identify and mitigate conflicts, identify and disclose material limitations placed on the securities or strategies, and prevent conflicts from causing the B-D to place its interests ahead of the customer's interest. Sales contests, sales quotas and other compensation tied to the sale of specific securities within a specific period of time are no longer permitted. Finally, the Compliance Obligation requires B-Ds to establish, maintain and enforce written policies and procedures to achieve compliance with Reg. B.I. as a whole. Credit unions will soon see potentially significant changes to B-D compensation programs, supervisory procedures and policies, and overall conflicts analysis.

The New CFP Standards

Since 2007, CFPs have had a limited fiduciary relationship with their clients, applicable only when the CFP "provides financial planning or material elements of financial planning." Most CFPs, however, provide far more than just financial planning. They also provide the same array of investment services provided by non-CFP RRs. The new CFP Standards, effective Oct. 1, 2019, but not enforceable until June 30, 2020, expand the CFP-client fiduciary relationship to encompass these everyday client interactions of buying and selling investments. The new CFP Standards establish that a fiduciary standard now applies at all times when a CFP is providing "Financial Advice," in addition to when a CFP is engaged in financial planning. More specifically, the new CFP Standards state, "At all times when providing Financial Advice to a Client, a CFP professional must act as a fiduciary, and therefore, act in the best interests of the Client."

"Financial Advice" is defined broadly and encompasses all "communication that, based on its content, context and presentation, would reasonably be viewed as a recommendation that the Client take or refrain from taking a particular course of action with respect to … the value of or the advisability of investing in, purchasing, holding or selling Financial Assets; investment policies or strategies, portfolio composition, the management of Financial Assets or other financial matters; the selection and retention of other persons to provide financial or Professional Services to the Client; or the exercise of discretionary authority over the Financial Assets of a Client."

Although the new CFP Standards contain a litany of duties and obligations running to the clients, the CFP's employer and the CFP board, the key obligations are set out in three primary categories as follows:

Duty of Loyalty: A CFP must: Place the interests of the client above the interests of the CFP and the CFP's employer; either avoid conflicts of interest, or fully disclose all material conflicts of interest to the client, obtain the client's informed consent and properly manage the conflicts; and act without regard to the financial or other interests of the CFP, the CFP's employer, or any individual or entity other than the client.

Duty of Care: A CFP must act with the care, skill, prudence and diligence that a prudent professional would exercise in light of the client's goals, risk tolerance, objectives and financial and personal circumstances.

Duty to Follow Client's Instructions: A CFP must comply with the terms of the client engagement and follow all directions of the client that are reasonable and lawful.

As we move into 2020, credit unions with a brokerage force (and those considering expanding into investment services) must fully appreciate that attached to these services are fiduciary duties that run between their RR and CFP employees and the credit union's members. With these new obligations are potentially higher risks of liability and financial and reputational exposure for the credit union that need to be addressed now in a collaborative effort with legal and compliance, the credit union's B-D and the credit union's investment workforce. ■