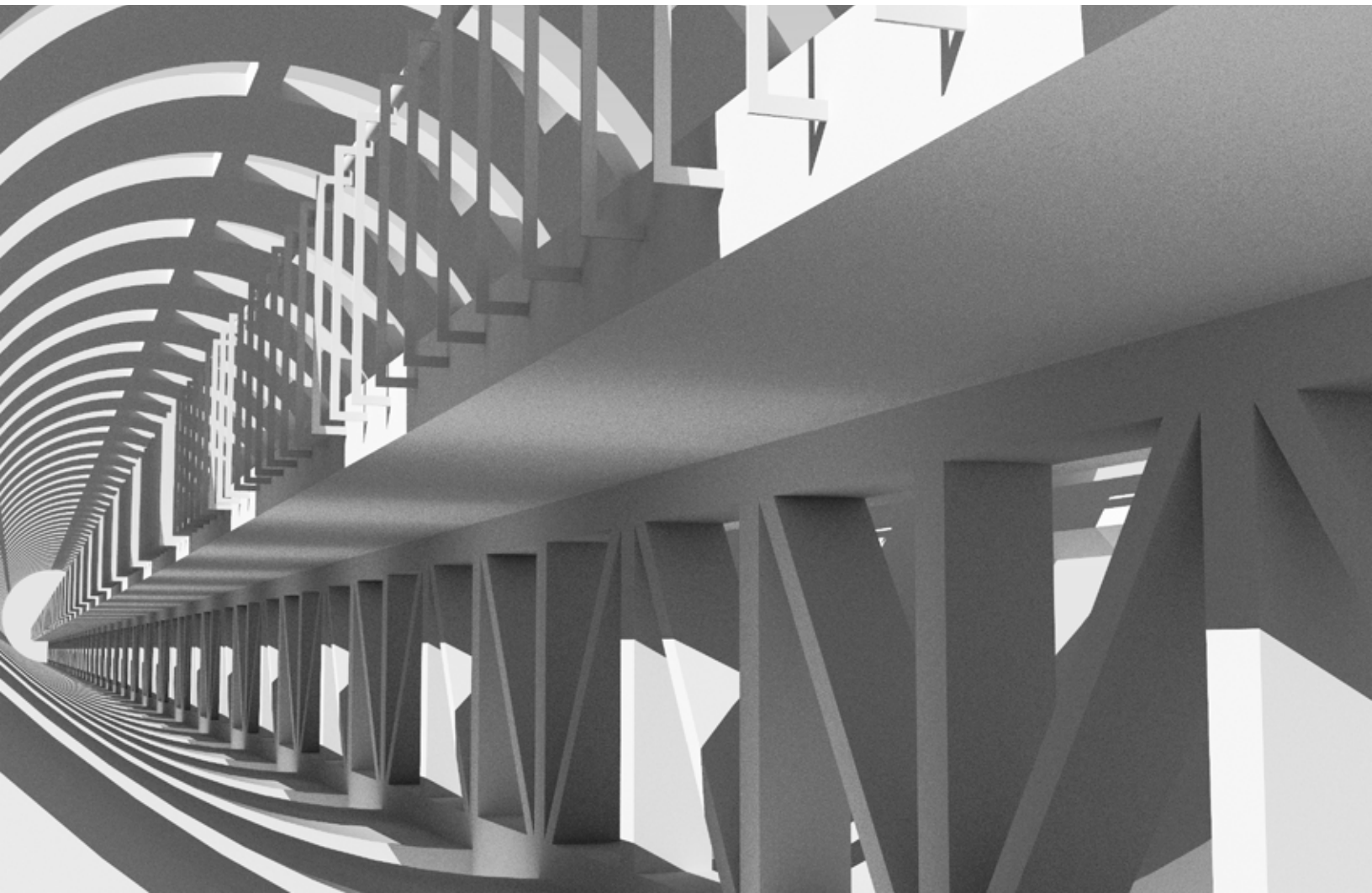


# CAPCO

## COVID-19 AND ITS IMPACT ON SEC REG BI

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COMPLIANCE CHALLENGES, A POTENTIAL AREA OF INCREASED FOCUS, AND HOW FIRMS SHOULD EVALUATE THEIR STRATEGIC RESPONSES CONSIDERING COVID-19



# ABSTRACT

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As firms prepare for a June 30 compliance date for SECs Reg BI, the enclosed article provides a unique perspective on potential implications as a result of the COVID-19 pandemic. The article offers answers to questions such as what are some of the challenges wealth managers have faced in complying with Reg BI? What area of the rule could be of heightened interest to regulators and clients given today's financial climate? How are firms ensuring they see the forest for the trees when implementing their Reg BI response?

# WHAT IS SEC'S REGULATION BEST INTEREST?

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SEC's Regulation Best Interest (Reg BI), passed in June 2019 and is expected to take effect in June 2020. Reg BI is a new rule that raises the standard of conduct and care for a broker-dealer (or associated persons), beyond existing suitability obligations, to act in the best interest when making recommendations to retail clients. The rule marks a paradigm shift within the wealth management landscape. It will soon dictate how our clients will offer investment services, and in turn, how they build new technologies, enhance CRM capabilities, and beyond. Reg BI will undoubtedly transform the competitive landscape and disrupt current business models, particularly for financial institutions that are reliant on traditional broker-dealer activities.



# WHAT ARE SOME OF THE CHALLENGES WEALTH MANAGERS HAVE FACED IN COMPLYING WITH REG BI?

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The SEC has set June 30, 2020, as the official compliance date for implementation of Reg BI, which the SEC has touted as ‘sufficient time’ for wealth managers to comply with the requirements. In November, however, Finra CEO and President Robert Cook said complying with Reg BI will be “a heavy lift, something that the firms need to be spending a lot of resources on.”<sup>1</sup>

On April 2nd, Chairman Jay Clayton of the SEC squashed any notion of a potential delayed implementation timeline. He announced that “because the continued implementation of [Reg BI], will significantly benefit Main Street investors—we believe that the June 30, 2020 compliance date for Reg BI and other requirements, including the requirement to file and begin delivering Form CRS, remains appropriate.” He went on to recognize the significance of the regulatory enhancement and the time and resources firms have been dedicating to comply and urged firms to forge forward as best as possible given the current circumstances<sup>2</sup>.

For most wealth managers, depending on the complexity of the organization, the fundamental shift in their business models have centered around product shelf rationalization, FA compensation, and related incentive programs, and changes to commission and/or fee schedules. As the final compliance date approaches quickly, our client’s face several implementation challenges when operationalizing the Reg BI obligation components. These challenges include mapping out the delivery and re-delivery model and trigger events for the Customer Relationship Summary (Form CRS), and adequately providing evidence for best interest rationale for specific types of recommendations. These wealth managers have been investing in new, or upgrading existing technologies to enable compliance with the rule and limit the disruption to how FAs currently serve their clients and engage with prospects. In addition, there is considerable focus

on bolstering their compliance frameworks and ensuring all conflicts of interest are identified and appropriately captured in their conflicts register while enhancing and or establishing new controls. This effort has been time-consuming and challenging in normal times, with firms exhibiting trepidation along the way regarding their ability to fully comply with the regulation by June 30th. Now, with a global pandemic, broker-dealers have justifiably shifted their priorities to business continuity planning, assessing their recovery readiness (in the event of a service disruption), creating strategies and playbooks to strengthen the business continuity of critical functions. Broker-dealers are now more worried than before about being able to be in full compliance by June 30. So, will the enforcement process be impacted?

As Chairman Clayton’s announcement indicated, the SEC will evaluate initial enforcement based on good faith efforts and take a more collegial approach to initial enforcement. Firms should collaborate with the SEC early and often to the extent that any filings or other requirements have been disrupted as a result of remote working conditions, or public safety guidelines. However, we firmly believe that in these unprecedented times, wealth management firms should not put their compliance efforts on hold, or even allow them to take a back seat. In trying and turbulent times, clients and regulators will likely question regulatory compliance more than ever and will likely not ease up on the thoroughness of their examinations. We believe wealth managers that effectively demonstrate their ability to comply with Reg BI by June 30 will gain a competitive advantage. Those wealth managers will show that they are at the forefront of the wealth management industry, and gain market share as they aim to provide their clients with the clarity and transparency they desire, and that aligns with the expectations of the rule.

# WHAT AREA OF THE RULE COULD BE OF HEIGHTENED INTEREST TO REGULATORS AND CLIENTS GIVEN COVID-19 AND TODAY'S FINANCIAL CLIMATE?

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We are navigating a unique event in market history, and market participants are unsure of what will happen next. Financial Markets are experiencing unprecedented market volatility, as demonstrated by the Volatility Index (VIX) reaching record highs, and surpassing previous peaks during the height of the 2008 financial crisis<sup>3</sup>. As we have seen in the past, increased volatility has implications on how investors, clients, advisors, and plan participants interpret and assess risk. Increased volatility, specifically impacts how retirement plan sponsors view risk, and it wouldn't be the first time their perspective on investing has changed. As we saw following the 2008 financial crisis, countless investors who were near-retirees lost a significant amount of their assets, as their target date-date funds, the most common default selection in 401(k) plans, average equity exposures were around 48 percent<sup>4</sup>. As volatility spiked during this period, retirement plan sponsors adjusted their menu options to create less risky target-date funds. However, given the 11-year bull market since the 2008 financial crisis, plan sponsors, once again, have increased their equity exposure in target-date funds. Today, the average equity exposure for a 63-year-old is at around 49 percent<sup>3</sup>, even higher than it was in 2008, and plan sponsors are likely to consider, once again, adjusting their 401(k) menus in response to the volatile financial markets.

Therefore, during this uncertain time, we expect clients will place more and more emphasis on evaluating the assets they have set aside for their retirement and will actively seek recommendations from their advisors regarding these types of accounts (employer-sponsored or otherwise). The changes to their 401(k) investment options might be the catalyst to more formally evaluate the need to move their assets from an employer plan into an IRA account.

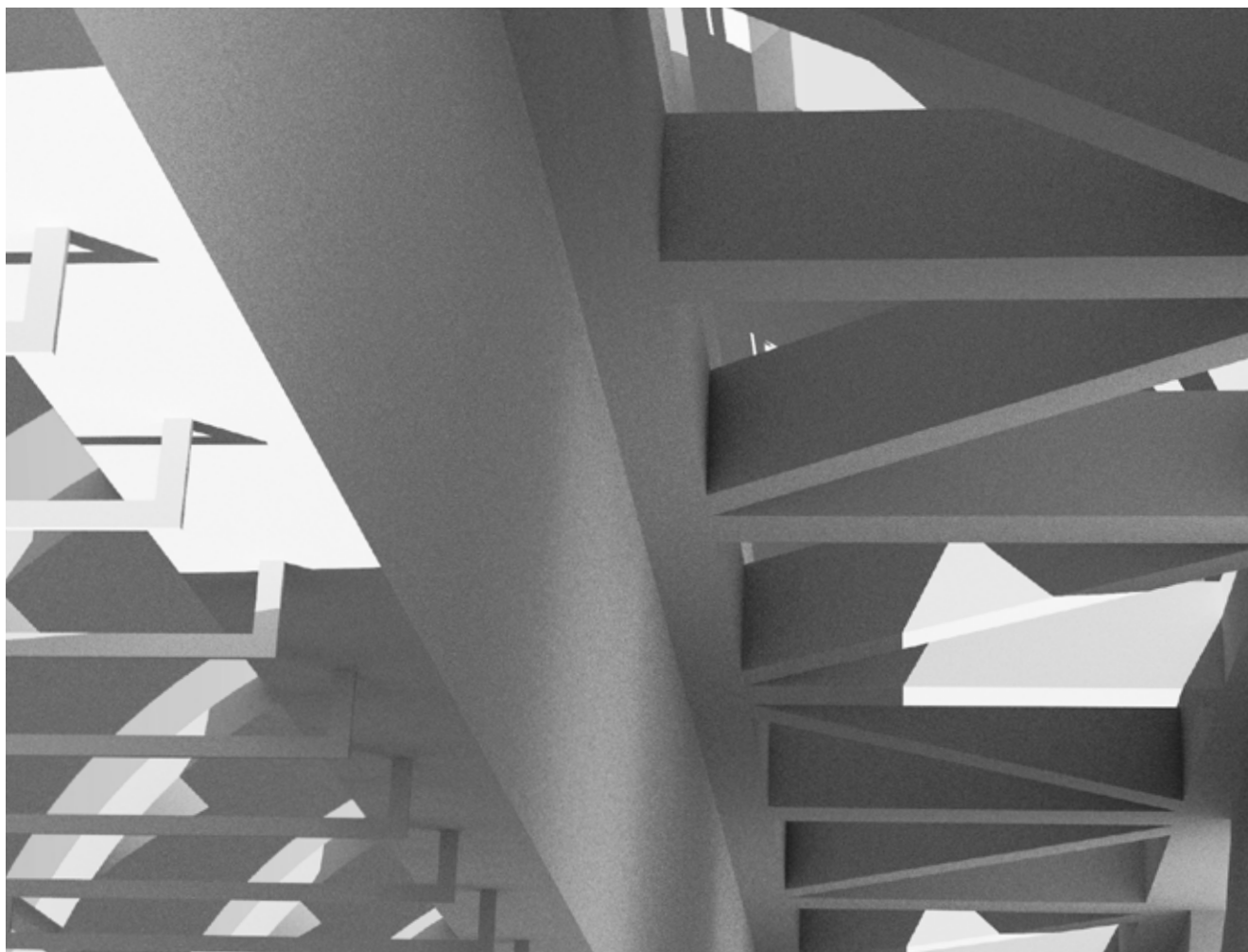
Clients will begin to be more sensitive to the investment options, features, and services of their employer plan relative to an IRA account. They will start to question things like the cost and performance differences between target-date funds and managed portfolios, the benefits of active management vs. passive funds, or whether they should pre-maturely dip into their 401(k)s given the access provided by the recent federal stimulus package<sup>5</sup>. This will be particularly true for 'Gen X' or 'Baby Boomers' who are closer to or already in retirement. Advisors will need to be prepared to field these influxes of questions, discuss the strategic distinctions for those in the accumulation vs. decumulation stages of retirement, and provide recommendations and advice (being mindful of a post-Reg BI environment).

Many have speculated that broker-dealers would respond to Reg BI by scaling back their propensity to provide rollover recommendations and instead, focus on education only. Other indications suggested that firms intending to support an advice model would choose to enable advisors to simply disclose that they didn't base their recommendation on a robust and detailed cost assessment and comparison. However, we believe that given the ripple effects from the current crisis, wealth managers may need to recalibrate these strategic decisions. There will likely be an increased propensity for clients, and prospective clients, to engage advisors in retirement planning and rollover based discussions, which could challenge their ability to execute under current envisioned processes and procedures. Now more than ever, wealth managers need to think critically about how they are currently documenting their rollover discussions and ascertain whether changes are required in light of the current environment to ensure effective compliance with Reg BI, in deference to



ERISA law. Reg BI mandates that all rollover recommendations by broker-dealers are subject to the rule's best interest requirement regardless of whether they involve securities transactions. The rule also states that, in addition to evaluating potential risks and incentives, wealth managers must always consider costs when making a recommendation<sup>6</sup>. Since rollover IRAs are typically more costly than employer-based retirement plan accounts, the wealth manager should be able to justify the added cost through additional benefits to the client based on their needs, goals, and objectives.

As a result of this heightened focus on retirement assets and accounts, we believe the characterization and consideration between investor education versus recommendations will be an unforeseen near-term focal point of initial enforcement. We urge wealth management firms to promote clarity and consistency in their approach. They can do this by reexamining FA recommendation workflows, adapting their field management and compliance policies and procedures, reviewing their supervisory flags, and revisiting their Reg BI tailored training programs.



# HOW ARE FIRMS ENSURING THEY SEE THE FOREST FOR THE TREES WHEN IMPLEMENTING THEIR REG BI RESPONSE?

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A tidal wave of change will undoubtedly flow through the wealth management industry over the next few quarters. In light of the current crisis, we believe firms will need to revisit their existing assumptions, initial strategic responses, and specific areas that may not have previously been of high priority. We've found that firms that evaluate the anticipated changes to their business practices through the lens of the client lifecycle are in the best position to pivot if required. A diagnostic exercise that maps the FA and client journey is a helpful way to validate that the anticipated business model changes satisfy all components of the rule and ensure an effective program is in place to achieve full compliance. Further, the exercise provides an opportunity to diagnose and triage the areas that they may need to recalibrate or require additional attention due to the potentially lasting effects of current market dynamics. Below are three critical considerations that firms should keep in mind when undergoing such an exercise in the context of this regulation:

**1. Ensure that the firm's decisions reflect the typical day in the life of a financial advisor and the interactions with their clients.**

Responding to Reg BI is operationally complex, especially for large wirehouses. Often we see firms struggle with safeguarding against a bifurcated decision-making process. This exercise proves to be an effective way to ensure that there's continuity in the overall process, creates clear traceability to the obligation components of the rule, and highlights the implications of the totality of the changes on the end-to-end advisor and client experience.

**2. Reevaluate day one versus day two priorities.** Often, you have to implement rules like Reg BI under tight time constraints, and firms are naturally struggling with the trade-offs between implementing tactical, often manual, solutions to comply with the rule in June, versus investing in more sustainable and user-friendly solutions. As our retirement account case study illuminates, we are living in a different world than when Reg BI was first announced, and client needs, and therefore enforcement priorities, may have shifted. Firms should use this experience mapping exercise to reevaluate their initial day one versus day two trade-offs to ensure they still make sense.

**3. Leverage the client lifecycle as a foundation for an overall operational readiness assessment.**

The exercise will also prove to be an effective way to confirm not only that the firm has identified all of the Reg. BI impacts and required changes to achieve compliance with the rule, but also informs advisor training, provides opportunities for additional enhancements, and acts as the foundation for an overall operational readiness assessment. The exercise allows firms to create real-life, testable scenarios that they can use to simulate and benchmark their overall readiness.

Overlaying the firm's anticipated Reg BI-related changes across the client lifecycle is a worthy and timely exercise. The exercise will not only effectively prepare firms to align with regulatory guidelines but allow them to adapt their decision-making process to contemplate our new normal.

## CONTACT

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