

Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter Archive Message #694

Date:05-Jun-18

Subject: Mary E. Vandenack & the SEC's Proposed Interpretation of Standard of Conduct for Investment Advisers

“The SEC has proposed a package of rules and interpretations to enhance the protection of retail investors. Such rules and interpretations seek to enhance investor understanding of the nature and duties of investment professionals. Specifically, the SEC has issued an interpretation of the fiduciary obligation of investment advisers to clients. The SEC has also proposed Regulation Best Interest, which imposes certain obligations on broker-dealers to act in the best interest of a retail investor. The SEC has also issued a proposed rule requiring investment advisers and broker-dealers to issue Form CRS – a disclosure document clarifying the nature of the relationship between the financial professional and the retail investor. This commentary covers the interpretation of the fiduciary obligation of investment advisers. This commentary will be followed by commentaries on the Best Interest Rule and Form CRS.”

Mary Vandenack provides members with important commentary that analyzes the SEC's proposed interpretation of standard of conduct for investment advisers.

Mary E. Vandenack is founding and managing member of **Vandenack Weaver LLC** in Omaha, Nebraska. Mary is a highly regarded practitioner in the areas of tax, benefits, private wealth planning, asset protection planning, executive compensation, equity fund development, business and business succession planning, tax dispute resolution, international tax, state and local tax, and tax-exempt entities. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers, companies in the financial industry, and tax exempt organizations. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves as Co-Chair of the Futures Task Force, Co-Chair of the Technology and Economics of Law Practice Committee and Vice Chair of the Asset Protection Planning Committee. Mary is a member of the American Bar

Association Techshow Board and incoming Editor-in-Chief of Law Practice Magazine. She was named to the ABA LTRC 2018 Distinguished Women of Legal Tech. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on practice management topics including improving the delivery of legal services, technology in the practice of law, building sustainable law firms, and alternative fees for process-oriented law firms.

Here is her commentary:

EXECUTIVE SUMMARY:

The SEC has proposed a package of rules and interpretations to enhance the protection of retail investors. Such rules and interpretations seek to enhance investor understanding of the nature and duties of investment professionals. Specifically, the SEC has issued an interpretation of the fiduciary obligation of investment advisers to clients. The SEC has also proposed Regulation Best Interest, which imposes certain obligations on broker-dealers to act in the best interest of a retail investor. The SEC has also issued a proposed rule requiring investment advisers and broker-dealers to issue Form CRS – a disclosure document clarifying the nature of the relationship between the financial professional and the retail investor. This commentary covers the interpretation of the fiduciary obligation of investment advisers. This commentary will be followed by commentaries on the Best Interest Rule and Form CRS.

FACTS:

The Securities and Exchange Commission (SEC) has issued proposed rulemakings and interpretations intended to address retail investor confusion with respect to investment professionals. The SEC has proposed an interpretation to reaffirm and clarify the fiduciary duty that investment advisers owe to their clients. The SEC has also proposed that investment professionals be required to provide a disclosure document to clients that would clarify the nature of the relationship between the client and the investment professional. Additionally, the SEC has proposed Regulation Best Interest, which would require a broker-dealer to act in the best interest of a retail customer when making a recommendation regarding any securities transaction. As part of the SEC proposal, certain broker-dealers

and their financial professionals would be prohibited from using the terms “adviser” or “advisor” as part of their name or title with retail investors.

In recent months, we have had a Tenth Circuit rulingⁱ supporting aspects of the Fiduciary Ruleⁱⁱ and a Fifth Circuit ruling vacating the fiduciary rule.ⁱⁱⁱ In the Fifth Circuit ruling, the Court noted that the Fiduciary Rule was an invasion of SEC authority under the Dodd-Frank Act. (It is worthy of note that Congress voted recently to roll back parts of the Dodd-Frank Act.) The SEC rules, if finalized, are likely to accomplish much of what the Fiduciary Rule sought to do but on a broader scale.

COMMENT:

This Commentary will focus on the proposed commission interpretation regarding the standard of conduct for investment advisers.^{iv} Follow up commentaries will explain the proposed Best Interest Rule and proposed Form CRS.

A key element of the proposed interpretations and rulings by the SEC is to make clear the differences between the roles and duties of investment advisers and broker-dealers. The SEC does regulate both investment advisers and broker-dealers. The interpretation notes that Regulation Best Interest^v is intended to require that broker-dealers act in the best interest of retail customers but is structured in a manner that acknowledges the different nature of the relationship between broker-dealers and retail investors and investment advisers and retail investors. A significant aspect of the SEC proposed rules is a limitation on which financial professionals can use the term “adviser” or “advisor” when dealing with retail consumers.

An investment adviser is a fiduciary that is held to a high standard of care and has a duty to act in the best interest of the adviser’s client.^{vi} An investment adviser’s fiduciary duty includes a duty of care and a duty of loyalty.

Duty of Care

The duty of care consists of three components. The first component is a duty of the financial adviser to provide advice that is in the client’s best interest. For an adviser to make a recommendation that is in the client’s

best interest, the adviser must become familiar with the client's financial situation, the client's level of financial sophistication, and the client's investment experience. Additionally, the adviser must be clear about the client's investment objectives. That is, the financial adviser must develop a profile for the client that includes financial information, investment experience, and financial and investment objectives. This is typically referred to as the "investor's financial profile". Once a profile has been assembled, the financial adviser's role is to provide personalized advice based on, and giving consideration to, the details of the profile. The client's profile should be kept current by the financial adviser.

Personalized advice encompasses a reasonable belief by the adviser that recommendations to the client are suitable to the client based on the client's investment profile. There might be an investment or investment approach that would be in the best interest of the client generally but not when given the client's conservative nature. For example, investing in a particular security might be in the client's best interest but investing in that security on margin might not be.

Costs and fees associated with investment advice are important factors to be considered by the financial adviser in making recommendations to the client; however, the fiduciary duty does not always require that the adviser recommend the lowest cost option. In fact, in some circumstances, the recommendation based on lowest cost, without considering other factors, could be a violation of the adviser's fiduciary duty. If an adviser reasonably believes that a higher cost investment is in the client's best interest based on factors such as benefits, volatility, and performance, then advising the client to pursue such investment is reasonable. The adviser should always fully disclose costs and alternatives.

A financial adviser's duty to provide advice in the client's best interest applies not only to particular investments but to recommendations concerning investment strategy. Such duty extends to counseling a client to engage a sub-adviser on an account as well as to whether to rollover a retirement account to a particular adviser.

The second component of the duty of care by the financial adviser is the duty to seek best execution on behalf of the client. The duty to seek best execution includes an obligation to engage in transactions in a manner that the client's total cost for transactions is as favorable as possible under the

circumstances. This does not mean that the financial adviser must execute transactions in a manner that results in the lowest possible commission rate but rather that the overall range of qualitative execution is in the client's best interest.

The third component of the duty of care is the duty to act and to provide advice and monitoring over the course of the relationship. The frequency and scope of the monitoring and advice should be consistent with the agreement between the adviser and the client. If the adviser is compensated on a periodic asset-based fee, the duty to monitor and provide advice is particularly important.

Duty of Loyalty

The duty of loyalty requires that an investment adviser put the interests of the client before the interests of the investment adviser. The first aspect of this duty is that an investment adviser "must make full and fair disclosure of all material facts relating the advisory relationship."^{vii} Another aspect is that financial advisers must avoid conflicts of interest with clients. To the extent there is a conflict of interest, the adviser must make full and fair disclosure; however, disclosure is not always enough.^{viii}

Full and fair disclosure requires sufficient detail that a client can clearly understand the nature of the relationship with the advisor or in the event of a conflict, the nature of the conflict. The client should have enough information and understanding to make a reasonably informed decision as to how, or whether to proceed with the relationship or a particular transaction.

Financial advisers must treat different clients fairly and cannot favor a client account that pays a higher fee rate to the adviser than another account. The adviser must act fairly in allocating investment opportunities.

Financial advisers are required to disclose to clients all material facts that affect an advisory relationship. Advisers are required to provide an informational brochure to clients explaining the nature of the advisory relationship and disclosing conflicts. (The details required in the brochure will be covered in a separate commentary.)

The SEC is requesting comments on the proposed interpretation of the fiduciary duty of investment advisers.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mary Vandenack

CITE AS:

LISI Employee Benefits & Compensation Planning Newsletter #694 (June 5, 2018) at <http://www.leimbergservices.com>, Copyright 2018 Leimberg Information Services, Inc. (**LISI**). Reproduction in Any Form or Forwarding to Any Person Prohibited - Without Express Permission.

CITATIONS:

ⁱ *Mkt. Synergy Grp., Inc. v. United States Dep't of Labor*, 2018 U.S. App. LEXIS 6209 (10th Cir. March 13, 2018).

ⁱⁱ 29 CFR 2510.

ⁱⁱⁱ *Chamber of Commerce of the United States of America, et al. v. Hugler, et al.*, 231 F. Supp. 3d 152 (N.D. Tex. Feb. 8, 2017).

^{iv} 17 CFR Part 275 Release No. IA-4889; File No. S7-09-18.

^v 17 CFR Part 240 Release No. 34-83062; File No. S7-07-18.

^{vi} 15 U.S.C. 80b.

^{vii} Investment Advisors Act Release 3060.

^{viii} *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).