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What Your Next Deficiency Letter is Going to Say: SEC Tells Advisers What Fiduciary Duty Means

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With all the buzz about the passage of Regulation Best Interest ("Reg BI"), the "Commission Interpretation Regarding Standard of Conduct for Investment Advisers" (the "Interpretation") has received much less attention. Yet the Commission's discussion of how the standard applies sends a message to retail advisers that they may need to up their game or be cited for deficiencies during their next exam.

The SEC breaks down an adviser's fiduciary obligations into two basic duties, a duty of care and a duty of loyalty. The duty of care means an adviser must provide advice in the client's best interest, seek best execution where the adviser has the responsibility to select broker-dealers to execute trades, and monitor the client's portfolio over the course of the relationship. The duty of loyalty hinges on the adviser making full and fair disclosures of conflicts of interest to its clients so they can make an informed decision about whether to hire the adviser.

Many advisers understand their fiduciary duties conceptually, but the Commission provides specifics about its expectations in the Interpretation. Advisers failing to address these duties will undoubtedly see them mentioned in future deficiency letters, as noted below. Highlighted below are some expectations that are not always addressed in a firm's compliance program.

Privacy - Terms

Deficiency 1: Failure to Adopt, Implement, or Document Periodic Review of Client Accounts

The Interpretation states that the scope of an adviser's fiduciary duties depends on the types of clients the firm serves and the terms of the advisory agreement. Advisers serving retail investors have a greater burden of care and loyalty, since, as the SEC puts it, their clients have limited assets and investment knowledge. Moreover, if an adviser promises to provide comprehensive, discretionary advice as part of an ongoing relationship and charges a recurring fee for this service, the Commission expects the adviser to deliver on that promise. Similarly, if the adviser agrees to provide a financial plan for a fixed fee, then its obligations will be limited. In that case, the SEC would not expect an adviser to provide ongoing advice or monitoring of the client's investments.

Many retail advisers schedule an annual review with their clients to review their portfolios. The Interpretation requires more from advisers who agree to provide continuous discretionary advice and charge an ongoing fee. The SEC expects ongoing account monitoring. Many advisers perform periodic monitoring and rebalancing throughout the year (even if they don't discuss this with clients), but without the documentation to prove it, as far as the SEC is concerned, it didn't happen.

Recommendation

Advisers should implement a process to document periodic reviews. It may be as simple as requiring investment adviser representatives to review client holdings monthly or quarterly, comparing the holdings to the client's stated investment objectives, and noting whether there have been any changes to the client's personal situation that would require changes. The review should also address whether the client's current account or program type continues to be in the client's best interest (see discussion below). Investment adviser representatives should also consider the performance of the investments. The review could be retained in the client relationship management system or the client file.

Deficiency 2: Failure to Adopt, Implement, or Document a Policy for Selection of Account Types

The SEC takes the position that an adviser's fiduciary duty extends to *all* investment advice provided by the adviser, including account type. The Commission expects advisers to "consider all types of accounts offered by the adviser and acknowledge to a client when the account types the adviser offers are not in the client's best interest." Firms that are dually registered will need to consider whether a brokerage or an advisory account is most appropriate when advising clients on account types.

The Commission also highlighted advice to "rollover" retirement assets as being subject to an adviser's fiduciary duty to provide advice in the client's best interest. The Interpretation indicates that advisers recommending that clients roll over their assets from an employer-sponsored 401(k) plan to an IRA managed by the adviser will need to document the reasons why the recommended rollover was considered to be in the retirement investor's best interest.

Recommendations

Advisers should discuss with retail clients which account type best meets their needs and document the reasons for their recommendations. Firms should consider adopting standard criteria for making account recommendations. For example, commission-based accounts may be more appropriate for clients with smaller portfolios who do not expect to trade frequently (assuming the firm provides this type of account).

With respect to rollovers, the ill-fated Department of Labor's fiduciary rule provided guidance on how to meet the "best interest standard. Back then, we recommended that advisers recommending rollovers should:

- Gather information about the client's current financial situation and investment goals, as well as information about the client's current 401(k) plan to prepare a comparison of fees and expenses, services, and investment options of the plan to the IRA solution recommended by the firm.
- Educate the client on options regarding the assets in their 401(k) plan, and the advantages and disadvantages of each. FINRA's Investor Alert, "The IRA Rollover: 10 Tips to Making a Sound Decision" provides an excellent, unbiased summary.
- Using the information gathered in the first bullet point, provide the client with a side-by-side comparison of fees and expenses, services, and investments options of the client's current 401(k) plan to the IRA solution the firm recommends.
- Discuss the advantages and disadvantages of an IRA rollover as it applies to that client's specific situation. FINRA Regulatory Notice 13-45 is a good starting point, since it provides a checklist of items to be considered when discussing an IRA rollover.
- Consider using a checklist to evidence your discussions with clients. Here is a sample.

Deficiency 3: Failure to Perform Conduct Due Diligence on Investments

Performing due diligence on investment products is essential to providing advice that is in the best interest of a client. The Commission cites the Larry Grossman case as a not-so-subtle reminder of the consequences of failing to investigate securities before recommending them to clients (disgorgement and an industry bar). More recently, the SEC fined Steve Morris Bruce, founder and CEO of Charter Capital Management, LLC ("CCM"), $40,000 for telling investors that he had conducted extensive due diligence on an investment, when in fact he had only made a few phone calls and conducted some Google searches. The SEC discusses the factors that should be considered, including costs associated with the product, which involves its "investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon and cost of exit." The SEC goes on to emphasize that an adviser's fiduciary duty is not satisfied by simply advising the client to invest in the "lowest cost (to the client) or least remunerative (to the investment adviser) investment product or strategy without any further analysis of other factors in the context of the portfolio that the adviser manages for the client and the client's objective."

Recommendations

- Document the due diligence performed on investment products being offered to clients, including the services of sub-advisers. Has a comparison been made to determine whether the products and services being offered meet the client's investment goals, have a decent performance record, and whether the fees being charged are reasonable compared to the market? Has the firm considered the risks and conflicts associated with the products and services, and does it have procedures in place to monitor risks and police any such associated conflicts of interest? The answers to these questions should be documented.
- Consider assembling a Product or Investment Committee to perform due diligence on investment products and engage representatives from portfolio managers, finance, operations, sales and client service, and compliance to participate.
- Evaluate the types of products and services the firm offers to determine whether they are appropriate for specific types of clients. Consider developing guidelines for financial advisers, including a recommended list. Recommendations of products should be based on pre-determined guidelines, not on incentives, to mitigate conflicts of interest.
- Train and supervise advisors to make sure that the recommendations are appropriate.

Deficiency 4: Failure to provide "Full and Fair" Disclosure of Conflicts of Interest

As part of its duty of loyalty, an investment adviser is required to identify and disclose material conflicts of interest in the Form ADV. The Interpretation, however, makes it clear that the SEC views ***all conflicts as material.*** Moreover, the Interpretation requires disclosure that is "clear and detailed enough for the client to make an informed decision to consent to the conflict of interest or reject it." Vague or boilerplate disclosures won't cut it.

To illustrate its point, the Commission discusses when it is appropriate to state that an adviser "may" have a conflict. The answer: only when the adviser is talking about a conflict that does not currently exist but could be reasonably expected to exist in the future.

The determination of whether disclosure has been "full and fair" depends on the type of client, the scope of services, and the conflict. Once again, to fully understand conflicts and their effects, the Commission focuses on the fact that retail clients generally require more detailed disclosure than institutional investors.

Significantly, the SEC notes that advisers have a choice to either eliminate conflicts or provide detailed, full and fair disclosure to clients. For example, advisers do not have to have pro rata allocation policies, or any specific method of allocation, as long as they disclose to clients how investment opportunities will be allocated. In another example, it would be acceptable for an adviser to allocate IPO shares only to institutional clients that meet a specific asset threshold, as long as this practice is disclosed to all clients. Interestingly, the SEC acknowledges in a footnote that "An adviser and a client may even agree that certain investment opportunities or categories of investment opportunities will not be allocated or offered to a client."

The SEC is expecting clear and detailed disclosure from advisers in the Form ADV, new Form CRS, and in discussions with clients. Advisers should consider reviewing their current Form ADV to determine whether the disclosure is sufficiently clear and specific to meet the "full and fair" standard. As noted by Robert Plaze, former SEC Deputy Director of Investment Management in an article from The Fiduciary Institute:

> ***[T]he disclosure has to be sufficiently robust to give a client the tools to understand what is in his best interest.***

So what meets the standard of full and fair disclosure? Check out this example of effective disclosure outside the financial industry. Credit goes to Daniel P. Guernsey, Jr., in his article for the University of Miami Law Review, Requiring Broker-Dealers to Disclose Conflicts of Interest: A Solution Protecting and Empowering Investors. He cites an example dealing with a hygiene rating system for restaurants implemented in Los Angeles County in 1998. Restaurants must

place a letter from "A" to "C" in their window to reflect their hygiene status, where an A-rating represents a cleaner restaurant than a C-rating. The posting requirement ultimately led to a reduction in food-related illnesses and "created economic incentives for good quality hygiene." [footnotes omitted] A 13.1% decrease in the number of hospitalizations for food-borne diseases was also attributed to the grading system.

The beauty of this system is that it is both simple and comparative. Customers can understand the ratings easily and compare restaurants based on their cleanliness. It is probably not practical to develop a similar rating system for investment advisory services, but it is possible to disclose conflicts in a way that is easy to understand and meaningful to potential clients.

Below are some draft disclosures designed to meet the "full and fair" standard for a hypothetical investment advisory firm called ABC Financial Services, LLC ("ABC"). There are two examples, one for conflicts related to proprietary products (adviser vs. client), and a second about conflicts in allocating initial public offerings (client vs. client).

(1) Conflicts Related to use of Proprietary Products

ABC Financial Services, Inc. ("ABC"), an investment adviser, manages mutual funds (the "ABC Funds") in addition to client accounts that invest in individual securities ("separately managed accounts"). ABC receives an advisory fee for these services, which is paid out of fund assets. This means that all investors in the mutual fund pay a pro rata share of this fee based on the amount they have invested. There are additional expenses involved in operating a mutual fund which are charged to fund investors. These expenses, including the management fee, are calculated as a percentage of fund assets and are called the fund's "expense ratio." Actively managed mutual funds, like those managed by ABC, have expense ratios ranging from 0.5% to 1.5%. The average equity mutual fund expense ratio in 2018 was 0.55%, while bond fund expense ratios average 0.48%.[1] If you invest $10,000 in a fund with an expense ratio of 0.50%, you pay $50 a year to cover fund expenses. The expense ratio is deducted from mutual fund assets on an annual basis and gets paid even if the fund has negative returns.

On an annual basis, the mutual fund's board, which includes members that are independent of ABC, reviews the advisory fee and other operating expenses to determine whether they are reasonable compared to other mutual funds.

Generally, mutual funds cost more to manage and administer that separately managed accounts ("SMA") because of their regulatory requirements (e.g., yearly independent audits, prospectus delivery, legal and administrative expenses), and many of those costs are passed on to investors. By comparison, SMAs are generally cheaper to administer, so investors pay less in fees than those invested in mutual funds. An SMA account owner owns the securities in his or her account

directly and can place limitations on the investments, as long as the adviser agrees. For clients with less money to invest, ABC typically recommends investing in mutual funds, including the ABC Funds, as opposed to an SMA. ABC makes this recommendation because mutual funds generally provide broader diversification with lower initial investment requirements than SMAs. The ABC Funds are managed by the same portfolio managers that manage the SMAs.

There is a conflict of interest between ABC and its clients when it recommends investments in the ABC Mutual Funds. ABC receives an advisory fee from clients based on the assets in their account, including assets invested in the ABC Funds. This means that ABC receives an advisory fee from the ABC Fund and an advisory fee from the client for managing his or her account. [Alternative 1: To mitigate this conflict, ABC excludes client investments in the ABC Funds from its fee calculation. Alternative 2: To mitigate this conflict, ABC must perform the same analysis on the ABC Fund that it would perform for any other mutual fund. ABC must determine that the investment meets the needs of the client by reviewing the fund's investment objective, its performance, and the fees charged as compared to other mutual funds available to ABC.]

To mitigate the conflict of interest, the advice provided by ABC's advisors does not take into consideration whether ABC will receive fees from its recommendation to purchase, hold, or sell ABC Funds or non-ABC investments. Advisory fees received by ABC and compensation paid to its employees, agents, and registered advisors do not vary based on the investment options selected, and the advisors who deliver advice are not compensated for, or based on, any recommendation or sales of specific securities. Moreover, investments recommended by ABC's advisors must be suitable for clients based on their investment objectives, risk tolerance, and investment timeline. ABC's investment committee also performs due diligence on the investments offered to clients and applies certain criteria concerning performance, investment costs, asset class, style consistency, and risk.

(2) Conflicts related to Limited Investment Opportunities (IPOs)

From time to time, ABC has the opportunity to invest client assets in securities offered in an initial public offering (IPO). In deciding whether to recommend an investment in an IPO, ABC considers a client's investment objectives, restrictions, tolerance for risk, the size of the client's account and its other holdings, and whether the client has available cash for investment. ABC also performs due diligence on IPOs to determine whether the securities are appropriate for client accounts. ABC's financial advisors and employees are prohibited from investing in IPOs.

Many accounts are too small to invest in IPOs because the investment will result in the account being overly concentrated in one security. Moreover, IPOs are typically riskier investments and not suitable for clients with conservative investment goals. IPO underwriters, in our experience,

avoid allocating shares to smaller retail accounts, since this increases their costs and administrative burdens. All of these factors lead to a conflict of interest among clients. Clients with larger portfolios will be allocated shares of IPO, while clients with less money to invest will not. Therefore, clients with less than $[x] assets under management with ABC will not receive an allocation of an IPO.

Recommendations

The Interpretation included the SEC's thoughts on required disclosures which I included below, along with a few other areas that advisers do not always address but should going forward. To the extent not already addressed, advisers should consider discussing these topics in the Form ADV Part 2A:

- The limitations on the advice and products being offered. If the adviser only offers proprietary products or products offered by its affiliates, clients should understand why and what this means. If an advisory firm recommends that clients invest in a mutual fund that the firm manages, this should be disclosed, along with an explanation as to how conflicts are mitigated and why the investment is in the best interest of the client.

- Special incentives. Firms should either specifically prohibit any incentives or rewards that might encourage employees from acting in the best interest of the clients, or have processes to mitigate the incentive by ensuring that investments are selected based on the client's needs and objectives. For example, a mitigating factor could be that the firm's compensation policy is based on neutral factors tied to the differences in the services delivered to clients and not the amount of payment received in connection with a specific investment recommendation.

- Investment monitoring. Advisers should address the extent and frequency with which they monitor client investments.

- Advisers should address how investments are allocated among clients, especially limited investment opportunities such as IPOs.

- Conflicts among clients. The SEC says that "it would be inadequate to disclose that the adviser has 'other clients' without describing how the adviser will manage conflicts between clients if and when they arise..." Typically examples of client vs. client conflicts occur when limited investment opportunities are allocated (e.g., some investment opportunities like IPOs are only allocated to institutional clients) and when similarly situated clients pay different fees for the same services (e.g., clients acquired as a result of an acquisition or merger may be subject to different fee schedules).

As a reminder, advisers should include "full and fair" disclosures in their Form ADV Part 2A addressing these topics:

- Payments made and received by the firm and its affiliates, including referral fees, revenue sharing, 12b-1 payments, shareholder servicing fees, and recordkeeping fees;
- Clients who may also have vendor or business relationships with the firm and whether they receive favorable treatment as a result of those relationships.
- Affiliated service providers, such as broker-dealers, custodians, consultants, or administrators, the extent to which the adviser uses these service providers, and how the firm mitigates conflicts of interest.
- Benefits the firm receives from service providers, such as providing access to educational seminars related to current products and industry issues. This disclosure should also include the firm's participation in sales events, conferences, and programs held by mutual fund distributors.
- Outside business activities of executives and IARs.

Deficiency 5: Failure to Seek Best Execution

The SEC only discusses best execution for one page in the Interpretation, which is surprising given the amount of time and attention that has been given to the topic in the 2018 OCIE Risk Alert Compliance Issues Related to Best Execution by Investment Advisers and Share Class Selection Disclosure Initiative. Even more surprising is the fact that the Interpretation only addresses a more traditional view of best execution, focusing on broker selection and execution quality. I do not, however, expect to see the SEC backing off from its expectation that advisers should take share class into account when selecting investments for their clients. Perhaps the Commission has simply said all it has to say on the topic for the time being.

Recommendations

In any event, the Risk Alert on best execution is an excellent resource for understanding what the SEC expects from an adviser's best execution program. Check out our prior blog posts here and here for more information.

There is one deficiency that I do not expect to see.

Failure to establish that the Adviser has a reasonable understanding of the client's objectives

The Interpretation states that "[t]he basis for such a reasonable understanding generally would include, for retail clients, an understanding of the investment profile, or for institutional clients, an understanding of the investment mandate." [footnotes omitted] The Interpretation recommends that advisers, "at a minimum, make a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience, and financial goals (which we refer to collectively as the retail client's "investment profile")." Most investment advisers have a process in place requiring completion of a questionnaire or client profile before opening an account. Institutional clients typically select investment advisers based on desired specific investment style and the firm's performance in a specific asset class and then provide their own investment guidelines and objectives.

Conclusion

The Interpretation is a must read for all investment advisers. The Commission provides its view on an adviser's fiduciary obligations. It is a clear message that advisers failing to address these duties with process, policies, and procedures will face the consequences, whether as deficiencies cited in an examination finding letter or, in more severe cases, an enforcement action.

[1] Information provided by the Investment Company Institute, Trends in Expenses and fees of Funds, 2018. https://www.ici.org/pdf/per25-01.pdf

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