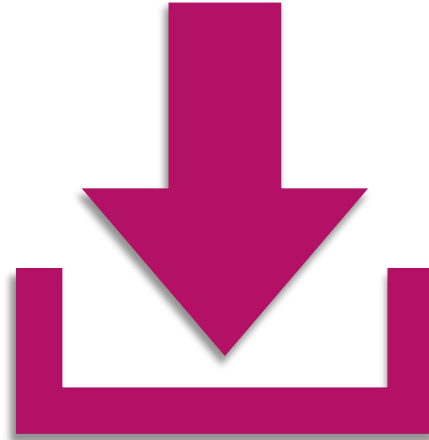




Duty of Care When Providing Investment Advice

Download Our Slides

<https://www.ria-compliance-consultants.com/duty-of-care-investment-advice>



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Already Effective As Of 1/1/24:

AR; CA; CO; FL; HI; KY; MD; MI; MS; NV;
ND; OK; OR; SC; TN; VT; DC; & WI.



Effective On 1/1/25:

U.S. Virgin Islands



Investment Adviser Rep Continuing Education

This Course Has Already Been
Approved by NASAA For 1
Hour of IAR CE Under Ethics
Category

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- ▶ **Login** - You must be logged in during the presentation under your email address.
- ▶ **View Entire Presentation** – You are required to watch the entire live presentation the course.
- ▶ **Attendance Codes** - As you watch the presentation, you will receive two attendance codes, each containing three alphanumeric characters. Save these codes. You will need to enter the full six-character attendance code prior to accessing the final quiz.
- ▶ **Login** – You will need to login into <https://www.CE4Advisers.com> and select/purchase this course.
- ▶ **IAR Acknowledgement** – Sign the IAR CE Acknowledgement & Attestation.
- ▶ **Final Quiz** - You must complete each lesson and receive a score of **70%** on the final quiz to receive IAR CE credit (assuming the course has been approved by NASAA).

Content Questions & Technical Help

If you have questions about the content of this course or need technical help, please contact us via the email address below:

ContEd@ria-compliance-consultants.com

Your Instructor



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Course Overview

- ▶ ***Fiduciary Duty Components***
- ▶ ***Duty of Care***
 - ***What Is Duty of Care***
 - ***Acting with Care When Providing Investment Advice***
 - *Understanding Investments & Clients*
 - *Available Alternatives*
 - *Risks vs. Benefits*
 - ***Best Execution***
 - ***Ongoing Advice & Monitoring***
- ▶ ***Waiving Fiduciary Duty***
- ▶ ***Questions***

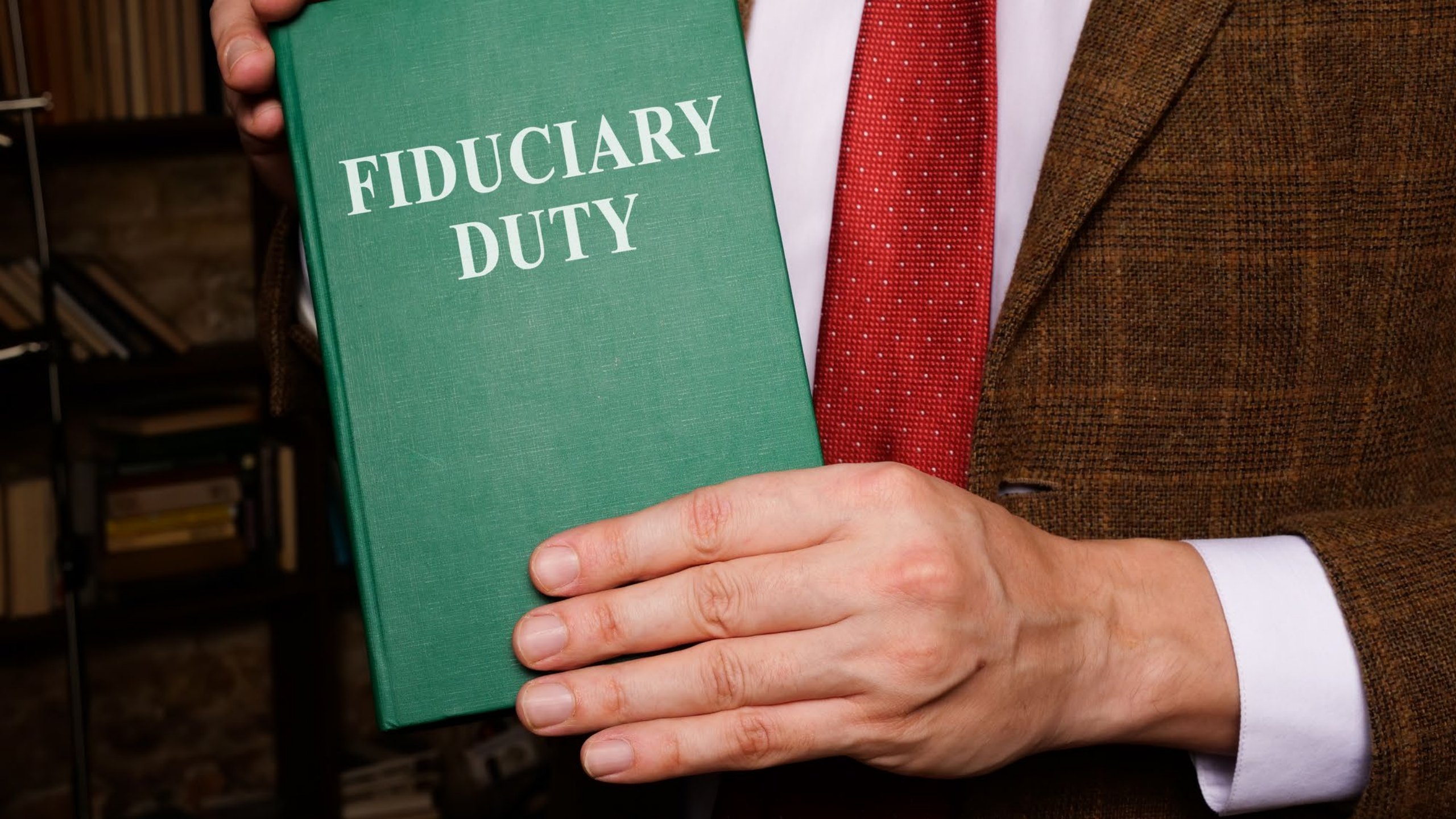
Regulatory Resources

Commission Interpretation Regarding Standard of Conduct for Investment Advisers (Effective 7/12/2019) @ <https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf>

Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (3/30/2022) @ <https://www.sec.gov/tm/iabd-staff-bulletin>

Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest (8/3/2022) @ https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest#_ftn1

SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations (4/20/2023) @ https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers#_ftn1

A close-up photograph of a person in a brown tweed suit jacket, white shirt, and red tie. The person is holding a green book with the words "FIDUCIARY DUTY" printed in white, serif, all-caps font. The book is held in the person's left hand, while their right hand rests on the bottom edge of the book. The background is dark and out of focus, showing what appears to be a wooden structure.

**FIDUCIARY
DUTY**

Fiduciary Duty - Background

Investment Advisers Act of 1940 Effectively Creates a Federal Fiduciary Duty



However Not Specifically Defined by Statute or Rule – Relying Upon Common Law & Congressional Intent



Fully Articulated by U.S. Supreme Court Case in SEC v. Capital Gains Research Bureau, Inc.

Follows Contours of the Relationship

*“Fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client **may shape that relationship by agreement**, provided that there is full and fair disclosure and informed consent”*

Waiving Fiduciary Duty

- ▶ May Not Waive Federal Fiduciary Duty
- ▶ Following Waiver Provisions Are Problematic
 - *Statement that Investment Adviser Will Not Act As Fiduciary*
 - *Blanket Waiver of the Conflict of Interest*
 - *Waiver of Specific Provision of the Investment Advisers Act of 1940*
 - *Waivers Within Indemnification Clauses*
- ▶ Waiver with a Savings Clause Viewed as Misleading by SEC (Depending Upon Client's Sophistication of IAA '40)
- ▶ But Fiduciary Duty Will Apply In A Manner That Reflects The Agreed-Upon **Scope** Of Relationship



Components of Fiduciary Duty Under IAA '40

Duty of Care

Duty of Loyalty

Limited Focus

This Course Doesn't Cover the Duty of Loyalty Component of Fiduciary Duty Such as Identifying, Disclosing and Mitigating/Eliminating Conflicts of Interest

The Course's Focus Is the SEC Staff's Guidance on Duty of Care

What Is Duty of Care?

Duty to Provide
Advice that Is in **Best
Interest of Client**

Duty to Seek Best
Execution of a
Client's Transactions
When the
Investment Adviser

Duty to Provide
Advice & Monitor
Over Course of
Relationship



Satisfying Duty of
Care When Providing
Investment Advice &
Recommendations

Understanding the Investment & Strategy

- ▶ Required to Make Independent & Reasonable Investigation of Investment or Strategy Before Recommending
- ▶ Must Develop Sufficient Understanding of Potential Risks, Rewards & Costs of Investment or Strategy
- ▶ Without Understanding, Can't Have Reasonable Basis To Believe Recommendation Aligns with Client's Profile



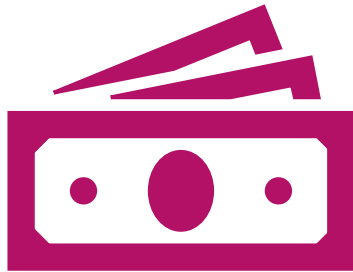
Reasonable Investigation:

- Initial & Ongoing Costs
- Investment Strategy & Objectives
- Characteristics (including any special or unusual features such as tax advantages, guaranteed payments, margin call terms or early repayment of debt underlying a securitized product)
- Liquidity
- Risks and Potential Benefits
- Volatility
- Likely Performance in a Variety of Market and Economic Conditions
- Expected Returns, Expected Payout Rates & Potential Losses
- For Retail Investors, Role of Investment or Strategy within Actual or Anticipated Portfolio
- Time Horizons
- Costs of Exit

Reasonable
Investigation

Where Providing
Ongoing Advice &
Monitoring, Required to
Continue Analysis of
Such Items Over Course
of Relationship

Must an Investment Adviser Recommend Lowest Cost Investment



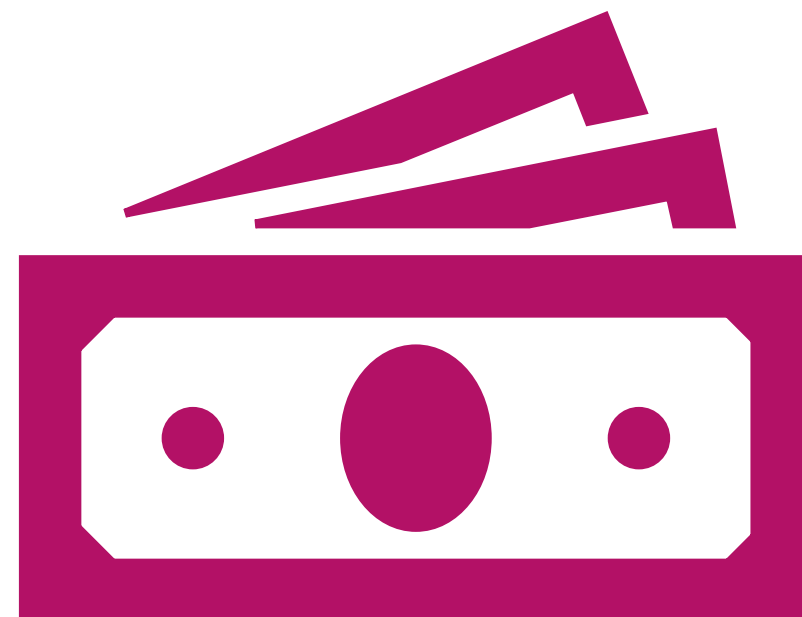
Best Interest Isn't Simply Advising Client to Invest in Lowest Cost Investment Without Any Further Analysis or Other Factors



"...[M]ust always consider cost as a factor when providing a recommendation or advice to a client."

Should Consider Total Potential Costs Including Direct and Indirect Costs to Client

- ❑ Commissions, markups/markdowns and transaction costs
- ❑ Sales loads or charges
- ❑ Advisory or management fees
- ❑ Fees or expenses that may affect a client's return (e.g., Rule 12b-1 fees, administrative fees, revenue sharing and transfer agent fees)
- ❑ Trading and other costs associated with an investment strategy (e.g., options or futures contracts, margin interest, daily rebalance fees)
- ❑ Costs of exiting an investment or investment strategy (such as deferred sales charges or liquidation costs)
- ❑ Any relevant tax considerations
- ❑ Likely impacts of costs over client's expected time horizon



Can
Investment
Adviser
Recommend
Higher Cost
Investment or
Strategy?


- Yes, If Investment Adviser Reasonably Concludes that Other Factors Outweigh Cost & Making Such Investment or Strategy in Client's Best Interest in Light of Client's Objectives

Example of High-Cost Investment Which May Be Consistent with Fiduciary Duty

It might be consistent with an investment adviser's fiduciary duty to advise a client with a high-risk tolerance and significant investment experience to invest in a private equity fund with relatively higher fees and significantly less liquidity as compared with a fund that invests in publicly-traded companies if the private equity fund was in the client's best interest because it provided exposure to an asset class that was appropriate in the context of the client's overall portfolio

Can IAR Rely Upon Firm's Review of Investment or Strategy

No – An IAR Can't
Satisfy Obligation by
Solely Relying Upon
Others at Firm



An IAR Is Responsible
for Personally
Understanding an
Investment or
Strategy Before
Providing Advice or
Recommending

Need An Investor Profile For A Retail Client

“In order to have a reasonable basis to believe a particular investment or investment strategy is in the best interest of a particular retail investor, you must obtain and evaluate enough information about the retail investor to have a reasonable basis to believe that the recommendation or advice is in the retail investor’s best interest.”



Client's Profile Should Include

Financial situation (including current income) and needs

Investments, assets and debts

Marital status

Tax status

Age

Investment time horizon

Liquidity needs

Risk tolerance

Investment experience

Investment objective and financial goals

Other information client may disclose related to the recommendation or advice

Understanding Client for Comprehensive Financial Plan

An investment adviser undertaking a comprehensive financial plan for a retail client would generally need to obtain range of personal and financial information about the client such as current income, investments, assets and debts, marital status, tax status, insurance policies and financial goals

What Does It Mean to Consider Client's Tax Status When Providing Advice or Recommendations?

- a. When Client Identifies a Goal with Tax Implications (e.g., saving for retirement or a child's education) or Seeks to Obtain a Tax Advantage (e.g., tax loss harvesting or limiting capital gains) as an Investment Objective, IAR Should Consider Whether Tax-Advantaged Option Is in Client's Best Interest
- b. Client's Tax Status Is an Important Consideration When Providing Advice Relative to Other Options
 - i. whether a fixed income investment pays taxable, tax-free, or deferred interest
 - ii. whether an out of state 529 plan is in the best interest of a customer who lives in a state that offers tax benefits for investing in the home state's plan
 - iii. whether a buy-and-hold or more frequent trading strategy is best for a particular account
- c. If Client Already Has 1 or More Tax Advantaged Investments, That Factor Generally Should Be Considered When Providing Advice or Recommendation About Another Tax-Advantaged Investment

Update Client's Investment Profile

Must Have a Reasonable Basis Believing Recommendation or Advice Is Not Based on Materially Inaccurate, Incomplete, or Outdated About the Client



Investment Adviser Needs to Update Retail Client's Investment Profile to Reflect Any Change Circumstances

- Frequency Depends Upon Facts and Circumstances

No Investor Profile Available

- ▶ Investment Adviser Should Generally Decline to Provide Investment Recommendation Until Obtains Client's Information
- ▶ If Investment Adviser Determines Not to Obtain Client Information Normally Within Investor Profile, Then Adviser Should Document Basis for Belief Info Is Not Relevant

Reasonably Available Alternatives

Must consider alternatives that are reasonably available to achieve the client's objectives

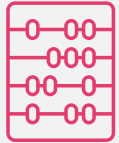
Consideration should begin early in the process of formulating a recommendation

Process for Identifying Reasonably Available Alternatives

Should have a reasonable process for identifying the scope of reasonably available alternatives

Analysis should begin with identifying investments consistent with client's profile, then narrowing to a smaller universe of potential investments

This includes guidance for IARs defining the scope of alternatives and the factors to be weighed in evaluating them



Reasonably available alternatives include those investments or investment strategies that could reasonably be offered by the firm and are consistent with the client's investment profile



Consideration should include the nature of the firm's business, customer base, relationship with customers, and the particular client's investment profile.

What
Constitutes
A
Reasonably
Available
Alternative

Single Best Alternative

No requirement to recommend the single "best" alternative

Multiple alternatives may be in the best interest of client

Documentation of Consideration of Reasonably Available Alternatives



- While no specific requirement to document consideration, firms may choose to do so as part of their compliance policies
- Documentation may include the process for identifying and evaluating alternatives, and the basis for determining that a recommendation is in the best interest of client

Considering Alternatives When Offering Proprietary Products

- Firms offering only proprietary products or a limited range of offerings must still consider reasonably available alternatives within that scope
- Firms must have policies and procedures to ensure that the limitations do not result in recommendations that place the firm's interests ahead of the client's interest.

Complex Products




Firms recommending complex products must have a deeper understanding of the products and consider reasonably available alternatives



Policies and procedures must be in place to ensure that recommendations are in the best interest of the client, considering the complexity of the products

Rollovers from Retirement Plans to IRAs

Must consider reasonably available alternatives when recommending rollovers from retirement plans to IRAs



Consideration should include the investment options, fees, expenses, services and penalties associated with both the existing plan and IRA

Example of Required Risk-Benefit Analysis

For A Client With A Conservative Objective:

Investing In Certain Derivatives May Be In Client's Best Interest When They Are Used To Hedge Interest Rate Risks In Client's Portfolio Whereas Investing In Directionally Speculative Derivatives On Their Own May Not

Example of Risk-Benefit Analysis

For A Client With A
Conservative Objective:

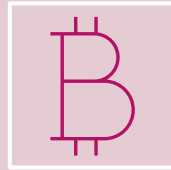
Investing In A Particular Security On Margin May
Not Be In The Client's Best Interest, Even If
Investing In That Same Security Without The Use
Of Margin May Be In The Client's Best Interest

Example of Risk-Benefit Analysis

For Sophisticated Client:

It May Be In The Best Interest of a Sophisticated Client (e.g., Private Such That Has The Appropriate Risk Tolerance) To Invest In Derivatives Or Securities On Margin

Example of Risk-Benefit Analysis



For High-Risk Investments (e.g.,
Penny Stocks, Thinly Traded
Securities):



Investment Adviser Should Apply
Heightened Scrutiny to Whether
Such High-Risk Investment Fall within
Client's Risk Tolerance & Objective

Example of Risk-Benefit Analysis

Complex Product:

For A Complex Product (e.g., Inverse or Leveraged ETFs) Designed Primarily For Short-Term Trading For A Sophisticated Investor May Not Be in Best Interest of a Retail Client Absent an Identified, Short-Term, Client-Specific Trading Objective

Duty to Seek Best Execution

Where Investment Adviser Has Responsibility to Select B-D to Execute Client Trades

Adviser Must Seek to Obtain Best Execution of Transactions for Each of Its Clients Such That Client's Total Cost or Proceeds in Each Transaction Are the Most Favorable – Goal Is to Maximize Value

Maximizing Value Means More Than Minimizing Cost

When Seeking Best Execution, Investment Adviser Should Consider

Value of Research Provided

Execution Capability

Commission Rate

Financial Responsibility

Responsiveness to Adviser

Investment Adviser Should Periodically and Systematically Evaluate Execution for Clients

Duty to Provide Advice & Monitor During Course of Relationship

Duty of Care Includes Duty to Provide Advice & Monitoring at Frequency that Is In Client's Best Interest of Client Taking Into Consideration **Scope of the Client Agreement**

Example – When Investment Adviser Has Ongoing Relationship with Client and Is Compensated with Periodic Asset-Based Fee, Investment Adviser Has Duty to Provide Advice and Monitoring As Is Consistent with Nature of Relationship.

Example – When Investment Adviser Does Not Have an Agreement with Client Regarding Monitoring and the Relationship Is of Limited Duration (e.g., one-time financial plan for a one-time fee), Adviser Is Unlikely to Have Duty to Monitor

Questions

Please submit any question online or email with any questions about the content of this course.

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Thank You

