Risk Management Update
March 2017

BEYOND THE DOL RULE – A LOOK AT SEC EXPECTATIONS FOR ADVISERS MANAGING RETIREMENT ACCOUNTS

The fate of the Department of Labor's ("DOL") Conflicts of Interest rule (the "DOL Rule") is uncertain. However, regardless of whether the rule gets delayed or repealed, the Securities and Exchange Commission ("SEC") continues to focus on the services being provided by investment advisers to retirement investors and seniors, along with the fees paid by such clients.

The SEC's Retirement-Targeted Industry Reviews and Examinations Initiative ("The ReTIRE Initiative")

The SEC is examining matters of importance to investors saving for retirement. Their ReTIRE Initiative has a few similarities with the DOL Rule and to show its importance, the SEC has featured this initiative prominently in their 2015,[1] 2016,[2] and 2017[3] SEC Examination Priorities letters.

In the June 2015 ReTIRE Initiative Risk Alert,[4] the SEC cited four specific areas they would be focusing on during their targeted exams:

1. Reasonable Basis for Recommendations
2. Conflicts of Interest
3. Supervision and Compliance Controls
4. Marketing and Disclosure

In this month's Risk Management Update, we discuss the SEC's main concerns surrounding these areas and provide suggestions for addressing associated risks that advisers may want to consider.

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[1] *See* National Exam Program Examination Priorities for 2015, SEC Office of Compliance Inspections and Examinations (January 13, 2015) available at: http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

[2] *See* National Exam Program Examination Priorities for 2016, SEC Office of Compliance Inspections and Examinations (January 11, 2016) available at: http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf.

[3] *See* National Exam Program Examination Priorities for 2015, SEC Office of Compliance Inspections and Examinations (January 12, 2017) available at: https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf.

[4] *See* National Exam Program Risk Alert Volume IV, Issue 6, "Retirement-Targeted Industry Reviews and Examinations Initiative", SEC Office of Compliance Inspections and Examinations (June 22, 2015) available at: http://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf.

Reasonable Basis for Recommendations

As a fiduciary, investment advisers must act in the best interest of their clients. Through the eyes of the SEC, this means, among other things, that investment advisers must recommend only suitable investments to their clients and have a reasonable basis for the recommendations made.[5]

The "reasonable basis" determination can present itself in a myriad of situations, including, for example, when an investment adviser recommends: (i) opening a wrap versus a non-wrap account, (ii) transferring assets from a 401k account to an IRA rollover, and (iii) investing in affiliated versus non-affiliated mutual funds.

Performing due diligence on investment options is necessary in order for an adviser to have a reasonable basis for recommending a particular investment option. The due diligence process can take a variety of shapes and forms, which can include using questionnaires and/or checklists. However, a crucial component of the process is maintaining appropriate documentation that substantiates the decisions made and the reasons for such decisions.

Suitability determinations also are an important part of the reasonableness determination. This can be challenging because suitability is subjective; however, there are some procedures firms can employ to align a client's suitability with investment recommendations. First, make sure adequate suitability information is being collected and documented. This would include, at a minimum, current age, planned age for retirement, current occupation and income, future income needs, net worth, investment goals and objectives, and risk tolerance. For senior investors, an investment adviser should consider collecting additional information, such as whether the client has an estate plan in place, and if so, how do the assets being managed fit into the plan. Then, after the information is collected and reviewed, recommendations can be made that are in line with each client's goals and objectives.

Suitability should be considered not only at the client level, but also at the individual security level and especially when additional fees are involved that are not readily apparent and could affect the performance of a client's account. For example, an investment adviser has an obligation to select mutual fund share classes that are the lowest cost available consistent with the client's eligibility, expected holding period, servicing expectations, and other relevant factors.

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5 *See* "Regulation of Investment Advisers by the U.S. Securities and Exchange Commission (March 2013)" at https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

Conflicts of Interest

As a fiduciary, an investment adviser must place the interest of clients ahead of its own and must not favor certain clients over others. All advisory firms have certain inherent conflicts of interest, with some firms having more than others. Inherent conflicts can exist as a result of business practices and affiliations, compensation arrangements, outside business activities of personnel (e.g. registered representative with broker-dealer), and even relationships with service providers. These are just a few areas that are ripe with conflicts, which is why regulators expect investment advisers to identify and address all material conflicts of interest though a process of elimination (when necessary), or mitigation and disclosure and also implement policies and procedures to monitor applicable conflicts and their associated risks.

The SEC continues to review investment adviser sales and account selection practices specific to retirement and senior clients, with a focus on how applicable conflicts of interest are being addressed. As outlined in the SEC 2017 Examination Priorities letter, as part of their continued ReTIRE initiative, they will be reviewing an adviser's "recommendations and sales of variable insurance products as well as the sales and management of target date funds."

Given this explicit regulatory agenda, advisory firms should ensure they have formal policies and procedures to identify and address conflicts of interest.

Supervision and Compliance Controls

Under Rule 206(4)-7 of the Investment Advisers Act of 1940 (the "Advisers Act"), investment advisers are required to have strong compliance programs in place. This includes, among other things, adopting and implementing reasonably designed written policies and procedures tailored to the firm's business model.

Of particular interest for the SEC are the supervision and oversight practices of advisory firms that have multiple branch locations[6] and personnel with outside business activities.

Supervision of personnel providing services to firm clients should be an area covered in the firm's written policies and procedures, including how personnel in branch offices are supervised. These also should address supervision and controls pertaining to providing services to retirement and senior clients.

Marketing and Disclosure

Firms must provide full and fair disclosure of all material facts. This can be accomplished via an adviser's Form ADV brochure as well as through advertising and marketing literature. Rule 206(4)-1(a)(5) of the Advisers Act prohibits an adviser from

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[6] *See* "Multi-Branch Adviser Initiative", SEC Office of Compliance Inspections and Examinations, National Exam Program Risk Alert Volume IV Issue 2 (December 15, 2016) available at: http://www.sec.gov/ocie/announcement/risk-alert-multi-branch-adviser-initiative.pdf.

publishing advertisements that are deceptive or misleading.

For this area, the SEC is focusing on whether: (i) marketing materials provided to retirement and senior clients include all relevant and required information, (ii) representatives have valid credentials and are not providing misleading endorsements, and (iii) adequate and accurate disclosures on fees effecting accounts are given to these clients.

Therefore, a CCO should review all firm advertisements including websites, social media and brochures to confirm the content is true, accurate and does not omit any material information when there is a duty to disclose. Also, when reviewing Form ADV a CCO should ensure that adequate disclosures are included pertaining to applicable conflicts and how the firm addresses the conflicts.

Conclusion

Regulators will continue to focus on the financial industry's treatment of retirement and senior investors. To that end, Chief Compliance Officers ("CCO") should perform a review to ensure they have a clear understanding of the recommendations being made to these types of clients by advisory personnel, the securities and investment products utilized, and the compensation received. From there, the CCO can determine whether additional compliance and supervisory controls are needed. At a minimum, these would include:

- Having a process for identifying the conflicts pertaining to recommendations made to retirement and senior clients;
- Implementing written policies and procedures that outline steps taken for addressing the applicable conflicts and the associated risks;
- Ensuring documentation is maintained that supports recommendations and investments made;
- Confirming suitability reviews are being performed and documented both initially and at least annually thereafter;
- Reviewing marketing and advertising to ensure accuracy and completeness; and
- Providing appropriate and detailed disclosures to clients.

Contact CCLS if you have questions regarding the SEC's ReTIRE initiative or would like to discuss how CCLS can help address any of the issues raised in this Risk Management Update. Email info@corecls.com or call (619) 278-0020.

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