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January 23, 2019

Nevada Proposes Sweeping Fiduciary Regulation

Background

On July 1, 2017, Nevada broker-dealers and investment advisers became subject to the state's financial planner statute (NRS 628A), making them fiduciaries to their clients and requiring them to submit to a rigorous disclosure regime. This legislation removed existing exemptions for broker-dealers, investment advisers and their respective representatives from the definition of a "financial planner." As a result, broker-dealers, investment advisers and their respective representatives are "financial planners" under Nevada law if they advise others for compensation upon the investment of money or upon provision for income to be needed in the future, or if they hold themselves out as qualified to perform either of these functions. As financial planners, they will now be subject to Nevada's statutory fiduciary duty with respect to advice that they provide to Nevada clients. Under NRS 628A.010, a "client" is a "person" who receives advice from a financial planner.

The statutory fiduciary duty specifically requires financial planners to "disclose to a client, at the time advice is given, any gain the financial planner may receive, such as profit or commission, if the advice is followed." The statutory fiduciary duty also requires financial planners, through a "diligent inquiry of each client," to make an initial determination of suitability of the advice to be given to each client as well as to evaluate such suitability on an ongoing basis. In making such determinations of

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suitability, the financial planner should consider "the client's financial circumstances and obligations and the client's present and anticipated obligations to and goals for his or her family." A violation of the statutory fiduciary duty by these regulated persons and entities will be a violation of the Nevada Uniform Securities Act.

Clients of financial planners have a statutory right of action if the financial planner (1) violates any element of the fiduciary duty, (2) is grossly negligent in the provision of advice to the client, in light of all of the client's financial circumstances known to the financial planner, or (3) violates any state law in the provision of investment advice. If any of the above violations occur, the client is entitled to recover, in a civil action, the amount of any economic loss resulting from the advice and all costs of litigation and attorneys' fees.

Since July 2017, the Nevada Securities Division has been working to further define the statutory fiduciary duty, as applicable to broker-dealers, investment advisers and their respective representatives, through the inclusion or exclusion of certain actions as violations and to prescribe means reasonably designed to prevent violations of the fiduciary duty.

The Proposed Draft Regulation

On January 18, the Nevada Securities Division released its long-awaited proposed draft regulation (Proposal). The Proposal begins by stating that a broker-dealer or its sales representatives will owe a fiduciary duty to its clients if it (1) provides "investment advice" (as defined below) to the clients; (2) manages the clients' assets;[1] (3) performs discretionary trading[2] of client assets; (4) who otherwise establishes a fiduciary relationship with clients;[3] or (5) uses the following titles and terms in their title, name or biographical description, or otherwise holds themselves out as having such role: (a) advisor/adviser, (b) financial planner/financial consultant, (c) retirement consultant/retirement planner, (d) wealth manager, (e) counselor, or (f) "other titles that the Administrator may by order deem appropriate."[4] A broker-dealer and sales representative are presumed to owe a fiduciary duty to the client.

Preemption

The Securities Division opted to have the Proposal be read "in harmony" with the Securities Exchange Act of 1934, as amended by the National Securities Market Improvement Act of 1996's recordkeeping requirements, thereby attempting to address some of the preemption concerns.

[1] We note that "assets" may not necessarily be limited to securities.

[2] The Proposal defines "discretionary trading" by what it's not, namely, that it does not encompass the "limited conduct of exercising discretion as to time and price of buying or selling a security that is based upon a client's direction, or transactions executed to satisfy customer margin obligations."

[3] It is unclear whether a fiduciary relationship established under federal law (e.g., Employee Retirement Income Security Act of 1974, as amended (ERISA)) would trigger fiduciary status here.

[4] A broker-dealer and sales representative will be presumed to owe a fiduciary duty to their client. This means that they would have the burden of showing that an exemption applies.

Key Definitions

The Proposal provides a detailed definition of "investment advice." Specifically, "investment advice" includes, but is not limited to:

A. Providing advice or a recommendation regarding the buy, hold or sale of a security to a client;

B. Providing advice or a recommendation regarding the value of a security to a client;

C. Providing analyses or reports regarding a security to a client;

D. Providing account monitoring for the purpose of potentially recommending a buy, hold or sale of a security;

E. Providing advice or a recommendation regarding the type of account a client should open;

F. Providing advice or a recommendation regarding the fee options available for the services provided by the investment adviser, representative of an investment adviser, broker-dealer, or sales representative;

G. Providing information on a personalized investment strategy;

H. Providing a financial plan that includes consideration of buying, holding, or selling a security;

I. Providing a limited list of securities for consideration by a client or by a limited group of clients that is tailored to the client or group of clients;

J. Providing information about a security that is not provided in the offering documents or is an opinion regarding the security or its potential performance;

K. Recommending a broker-dealer, sales representative, investment adviser, representative of an investment adviser, or financial planner; and

L. Providing advice or a recommendation regarding an insurance product or an investment by comparison to a security, or that includes the buy, sale or hold of a security.

The Proposal notes that "providing information about a security that is specifically contained in the security's offering documents is presumptively not investment advice unless, as part of the discussion, the investment adviser, representative of an investment adviser, sales representative, or broker-dealer recommends one product over another, recommends a buy, hold, or sale, or advises on the purchase, hold, sale, or value of a security to a client or limited group of clients." Moreover, communications regarding a general investment strategy that applies to the general public, or publishing an investment company ranking or a bond mutual fund volatility rating ranking consistent with FINRA rules, are not investment advice, provided they are "not targeted to any particular group or individual clients."

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Investment Advisers and their Representatives

The fiduciary duty also applies to investment advisers and their representatives. Notably, the Proposal provides that dual-registered entities and individuals who are both investment adviser representatives and "sales representatives" (presumably, registered representatives) will be presumed to be acting as investment advisers.

Scope

The fiduciary duty imposed on both broker-dealers and investment advisers generally includes the time period during which they provide investment advice, perform discretionary trading, maintain assets under management, act in a fiduciary capacity towards the client, disclose fees or gains, through the completion of any contract and through the term of engagement of services. Broker-dealers, but not investment advisers, may qualify for the Episodic Fiduciary Duty Exemption, which would limit the fiduciary duty to the specific investment advice provided but would not, unless otherwise required by law, have an ongoing fiduciary duty towards the client. This means that under the Episodic Fiduciary Duty Exemption, the broker-dealer or sales representative would not have an ongoing duty to keep informed about the client's financial circumstances and obligations.

The conditions of the Episodic Fiduciary Duty Exemption are:

A. The broker-dealer or sales representative does not manage the client's assets or perform discretionary trading for the client;

B. The broker-dealer or sales representative does not create periodic financial plans for the client, provide ongoing investment advice or enter into a contract to provide investment advice;

C. The broker-dealer or sales representative has not otherwise developed a fiduciary relationship with the client from previous or concurrent services undertaken on behalf of the client;

D. The broker-dealer *and* sales representative do not use the terms/titles described above;

E. The "facts and circumstances surrounding the transaction do not indicate that additional or ongoing investment advice is reasonably expected by the client relative to that transaction, type of product or advice"; and

F. The client solicited any investment advice.

The Standard of Care

The Proposal provides that the fiduciary duty is breached if the broker-dealer, investment adviser or their representatives, *inter alia:*

A. Fail to perform adequate and reasonable due diligence on a product or investment strategy prior to transacting a sale or providing investment advice;

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B. Recommend to a client a security or an investment strategy that is not in the client's best interest, or the recommendation or sale deviates from firm policies, offering limitations or other law;

C. Provide investment advice on a product or investment strategy without understanding or conveying all risks or features of the product or investment strategy;

D. Put their own interest, other clients' interests or the firm's interest ahead of the client;

E. Fail to provide current offering documents on the product prior to execution of the transaction;

F. Fail to disclose that a recommended product was a proprietary product or that the advice was based upon a limited pool of products, or fails to convey all material risks or features of the product;

G. Fail to adequately disclose all information regarding a potential conflict of interest;

H. Fail to comply with best execution rules;

I. Recommend or sell a security without disclosure of a bad actor disqualification as defined in Regulation D, Rule 506;

J. Recommend or charge a fee that is unreasonable;

K. Violate an applicable FINRA rule or other applicable self-regulatory organization rule that relates to client communications or disclosures;

L. Engage in conduct prohibited by NAC 90.321, 90.327 or 90.328 (relating to fraudulent and unethical practices); or

M. Limit the availability of securities to certain clients unless based upon a client's investment goals, a client's investment strategy, a firm's limitation of quantity or type of investment that can be sold to a client, or the security's own sale limitations.

Conduct That Is Not a Per Se Violation of the Fiduciary Duty

The Proposal sets forth three instances of conduct that do not amount to a per se violation of the fiduciary duty:

1. The sale of a proprietary product by a broker-dealer or sales representative alone is not a breach of the fiduciary duty, provided:

    a. The broker-dealer's and sales representative's conduct does not otherwise violate the law;

    b. The broker-dealer's and sales representative's conduct does not otherwise violate an applicable self-regulatory organization rule; and

    c. The broker-dealer and sales representative advised the client that the product is proprietary and advised the client of all risks associated with the product.

2. A broker-dealer, investment adviser and their representatives who hold or manage a client's position in cash do not breach the fiduciary duty based on that cash position alone if:

    a. They advise the client of all risks associated with the cash position;

    b. The conduct does not otherwise violate the law; and

    c. All applicable self-regulatory organization, custody and conduct rules regarding the cash position are followed.

3. A broker-dealer or sales representative's receipt of commissions does not breach the fiduciary duty provided the commission is both reasonable and in the client's best interest as opposed to other types of fees.

Exemptions

The Proposal sets forth three exemptions to the fiduciary duty standard:

A. A broker-dealer or sales representative who executes an unsolicited transaction for a client whose assets are not managed by the broker-dealer or sales representative, and has otherwise complied with all applicable rules, firm policies and procedures, unless the client receives investment advice (impliedly or explicitly), discretionary trading services, ongoing contractual services or a financial plan.

B. A broker-dealer who executes a trade in good faith that was recommended to a client by a registered or licensed investment adviser or representative, and who has otherwise complied with applicable laws, rules, firm policies and procedures, provided the broker-dealer does not provide investment advice, asset management, discretionary trading or a financial plan to the client.

C. A clearing firm that receives a direct instruction for the execution of a transaction from a properly registered or licensed broker-dealer, provided the clearing firm has acted in good faith and has otherwise complied with all applicable laws, self-regulatory rules, and firm policies and procedures.

Disclosure Requirement

As a general rule, if a broker-dealer, investment adviser or their representatives receive certain types of fees or "gains" "as a result of a client following their advice," then such compensation needs to be disclosed to the client no later than at the time the advice is given. The types of compensation included are (a) percentage of managed assets fee, (b) commissions, (c) markups or markdowns commissions, (d) market-maker commissions (electronic communication network rebates or credits), (e) discounts based upon number of transactions or clients, (f) management fees, (g) deferred or trailed fees or commissions, (h) front-end loads or back-end loads, (i) service fees or (j) payment for order flow. The Proposal explains that "gain" excludes "the profit or gain [that] may accrue as a result of all business activities."

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The Proposal contains a number of caveats:

A. Where the actual amount of the gain is not known at the time of the advice, the firm and representative would need to disclose to the client that a gain will be received and the manner by which the gain is calculated, and the amount actually received, is provided to the client within a reasonable time period (i.e., within a time period permitted under applicable law or SRO rules).

B. A firm or its representatives that charge the client a fee based upon a specific percentage of assets under management, and where those charges are "regularly" provided consistent with "other firm documents and law," need not disclose such fees at the time of the advice.

C. The receipt and amount of finder's fees, referral fees and "other benefit" for referrals to firms (brokerage and advisory), their representatives and/or a "financial planner" must be disclosed to the client at the time of the referral, along with any applicable contracts relating to the referral.

Our Initial Impressions

Some of our impressions of the Proposal are:

A. The Proposal, if adopted, would impose new and additional requirements on both broker-dealers and investment advisers.

B. It remains unclear whether investment advice to plan participants, fiduciaries, investment managers or entities would fall within the scope of the Proposal.

C. For all intents and purposes, broker-dealers and registered representatives are foreclosed from using the following titles, or otherwise holding themselves out as, (a) advisor/adviser, (b) financial planner/financial consultant, (c) retirement consultant/retirement planner, (d) wealth manager or (e) counselor, because doing so would disqualify them from relying upon the Episodic Fiduciary Duty Exemption. Use of such titles would mean that broker-dealers and their representatives would owe a continuing fiduciary duty to their client even after the transaction at issue was consummated.

D. The Securities Division reserves the right to add to the list of terms and titles that connotate fiduciary status, creating an uncertain business environment for firms. Commenters may wish to have a final regulation confirm that any additional titles will not have retroactive effect.

E. Dual registrants and their affiliates should pay particular attention to the Proposal.

F. The definition of "investment advice" appears to go well beyond existing definitions and interpretations under federal law. For example, the definition refers to both "advice" and "recommendations" without explaining how the terms differ and how a recommendation can amount to advice. Moreover, seemingly any information about a specific security provided to a specific client could be deemed to constitute investment advice, even such general information as price and historical performance. Though the Proposal indicates that the provision of information about a security "that is specifically contained in the security's offering documents is presumptively not investment advice," it leaves open-ended whether providing general information not contained in such documents would give rise to investment advice. The Proposal does not unequivocally state that general information about a specific security to a specific client is not advice.

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G. There is uncertainty over the scope and application of the Episodic Fiduciary Duty Exemption.

H. The Proposal is silent on whether and how the fiduciary status (or inability to rely on an exemption) of a representative applies to the entire firm (and its other representatives).

I. The Proposal helpfully indicates that the sale of proprietary products is not a per se violation of the fiduciary duty, but the firm or the representative would need to inform the client that the product is proprietary and advise the client "of all risks associated with the product." The Proposal does not define the term "risks" or the level of materiality triggering risk disclosure. Broker-dealers may wish to have this condition clarified to provide that disclosure in a manner consistent with federal law would satisfy this condition.

J. Firms should carefully review the proposed disclosure requirements regarding fees and gains, which may create substantial operational burdens.

K. The Proposal suggests that the mere *holding* of client cash could create a fiduciary obligation under certain circumstances. The Proposal curiously provides that a firm (broker-dealer or investment adviser) could, under certain circumstances, be subject to a fiduciary duty simply by holding or managing the client's position in cash.

L. The Proposal states that the fiduciary duty standard of care extends to the time during which a broker-dealer "maintains assets under management," even though the fiduciary duty is supposed to apply, in pertinent part, only when broker-dealers "manage" assets or perform "discretionary" trading. This could potentially ensnare custodial functions after investment advice was given. We don't necessarily think this conclusion is the Securities Division's intent, but it may make sense to seek clarification.

M. Commissions are seemingly preserved as a method of compensation, but the Proposal imposes "best interest" and "reasonable compensation" requirements. Unfortunately, the Proposal fails to define "best interest" or otherwise provide any guidance on how a firm could demonstrate satisfaction of such requirements.

N. Clearing firms are potentially ensnared by the Proposal, as they are covered by an exemption that contains a number of conditions. This seems to assume that clearing firms could otherwise be subject to the fiduciary duty.

O. Brokerage firms may be deemed to be exercising trading discretion, and, therefore, subject to the fiduciary duty, for selecting the trading venue from which to buy or sell a security on behalf of a client.

P. A breach of fiduciary duty would occur if a firm or representative provides investment advice on a product or investment strategy "without understanding" all of the risks and features of the product or strategy. It leaves to the imagination how a firm could ensure that its representatives *understand* risks and features of a product or strategy.

Q. The Proposal bars putting one client's interest ahead of another client's interest.

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R. The Proposal acknowledges the Securities and Exchange Commission's (SEC) preemptive authority under the Exchange Act with respect to broker-dealer books and records requirements, but is silent with regard to federal preemption of state authority under the Investment Advisers Act of 1940, as amended (Advisers Act), and ERISA; therefore, it appears the Securities Division is of the view that the Proposal, if adopted, would not be preempted under the Advisers Act and ERISA.

S. The Proposal authorizes the Securities Division to adopt any rule, form or exemption approved by the SEC for application to broker-dealers, investment advisers and their representatives so long as the adoption does not materially diminish the fiduciary duty under applicable Nevada law. This appears to give them the flexibility to adopt the SEC's best interest proposals (including Regulation Best Interest, if adopted). As a practical matter, we think this is unlikely given that the Securities Division opted to recommend the Proposal seemingly mere months away from the SEC's adoption of its own rulemaking package, and the numerous differences between the Proposal and the SEC's proposals.

Next Steps

Those interested in submitting a comment letter on the Proposal may do so by March 1, 2019. Written comments should be sent to Diana Foley, Nevada Secretary of State's Office, Securities Division, 2250 Las Vegas Boulevard North, Suite 400, North Las Vegas, Nevada 89030.

We expect that the Securities Division will hold a second workshop (open to the public) at some point, and, prior to a final rulemaking, a public hearing. It is unclear if the Proposal has been blessed by the Nevada Legislative Counsel Bureau at this point.

For more information, please contact:

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