Open Letter To The Department of Labor And SEC: Markets Deserve Clarification On The Duty Of Care

The ongoing debate over the Fiduciary rule has arguably done more to raise awareness than the actual rule itself ever will. Just look at the increased attention paid to "fiduciary duties". Sunlight is the best disinfectant, and this scrutiny should naturally help curb many of the conflicted practices that violate the Duty of Loyalty.

The Duty of Care, on the other hand, could use a little more sunlight. Many throughout the industry are still unclear as to how to fulfill the Duty of Care. This uncertainty, at least in part, is behind opposition to the rule.

We welcome the SEC's request for comment on the fiduciary rule and hope to see both the SEC and DoL work together to refine the fiduciary rule in a way that improves access to high-quality advice for all investors.

The first order of business should be to place a higher priority on defining the "Prudent Man" standard underpinning the Fiduciary Duty of Care.

What Would A Prudent Man Do?

The DOL has been quite vague in its comments about the Duty of Care. The only recent reference we found is in the most recent FAQ, where it cites the Prudent Man standard, which states that a fiduciary will act

> "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

This hypothetical "prudent man" represents an impossibly vague standard for advisors and investors. Cases such as GIW Industries, Inc. v Trevor, Stewart, Burton, & Jacobsen Inc. and Donovan v. Mazzola have brought a little clarity to the concept, but much ambiguity remains.

As financial planning expert Michael Kitces wrote in January of this year, this ambiguity raises the possibility for damaging class action lawsuits under the current regulation. Defining prudent advice or investment recommendations has never been done before, but if there were ever a time to do it, it is now.

We propose the DoL and SEC start by requiring that all investment recommendations be backed by research that meets the following criteria. How can anyone argue that investment research should not be:

- **Comprehensive**. It should reflect all relevant publicly available information (i.e. all 10-Ks and 10-Qs), including the footnotes and MD&A.
- **Objective**. Investors deserve unbiased research.
- **Transparent**. Investors should be able to see how the analysis was performed and the data behind it.
- **Relevant**. There must be a tangible, quantifiable connection to investment performance.

The average client would probably be surprised to learn that these criteria are not already required for investment research.

Diligence Matters

Due to increasing complexity and length of annual and quarterly financial reports, meeting these criteria requires a focused effort and, perhaps, significant changes in the way research are created by most firms.

Recent advances in machine learning and cloud computing have opened the door to technology that can produce the research investors deserve. That said, the proliferation of this technology faces challenges from the very nature of the investment advice business and the endemic conflicts of interests it has with clients.

Consequently, leadership from the SEC and DoL on the prudent man front is just as important to the integrity of the capital markets as it is for the duty of loyalty. Clearer guidelines would help wealth managers and regulators with compliance and reassure investors that they are getting value for their fees. The DoL and SEC have an opportunity to give meaningful clarity to the investment community. We hope they do so.

Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

This article originally published on July 24, 2017.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

New Constructs® - Research to Fulfill the Fiduciary Duty of Care

Ratings & screeners on 3000 stocks, 450 ETFs and 7000 mutual funds help you make prudent investment decisions.

New Constructs leverages the latest in machine learning to analyze structured and unstructured financial data with unrivaled speed and accuracy. The firm's forensic accounting experts work alongside engineers to develop proprietary NLP libraries and financial models. Our investment ratings are based on the best fundamental data in the business for stocks, ETFs and mutual funds. Clients include many of the top hedge funds, mutual funds and wealth management firms. David Trainer, the firm's CEO, is regularly featured in the media as a thought leader on the fiduciary duty of care, earnings quality, valuation and investment strategy.

To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.