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SEC Proposes a Code of Ethics That Holds RIAs to a Fiduciary Status. Can the NASD Be Far Behind?

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Have you ever wondered why financial services firms supporting financial advisors don't acknowledge the fiduciary responsibility associated with their financial advisors rendering counsel to their clients?

Virtually all financial services firms that support financial advisors maintain their advisors are not making investment recommendations. They are simply helping investors explore their investment alternatives. To avoid fiduciary liability, the financial services firms that support us have structured client relationships in such a way that financial advisors do not, in fact, provide investment counsel which, in turn, results in investors having to exercise their own judgment in making investment decisions. This minimizes or eliminates any fiduciary liability associated with financial advisors advising clients, but it also minimizes the role, the counsel and the value of the financial advisor. This long-standing practice of not acknowledging fiduciary responsibility has crippled the logical evolution of the financial services industry, as investors want value to be added and advisors want to add value. Yet, in order for advisors to add value, they have to go outside the auspices of their supporting firm and personally develop the processes and technology necessary to address and manage a broad range of investment and administrative values required by regulatory mandate. Without institutionalized support or acknowledgement of fiduciary responsibility, an embarrassing series of ethical and fiduciary breaches have occurred which have shaken the confidence of the investor and have tarnished the image and reputation of the industry and its advisors.

CAN THE NASD BE FAR BEHIND IN ENSURING INVESTOR CONFIDENCE BY FINALLY ACKNOWLEDGING THE FIDUCIARY RESPONSIBILITY OF THE FINANCIAL ADVISOR?

Last week, prompted by an acceleration in the scandals which are unfolding across the industry, the Securities and Exchange Commission (SEC) voted to propose new rules which would require registered investment advisors (RIAs) to adopt a code of ethics which would hold the RIA to a fiduciary status. Given the NASD is the self-regulatory authority that governs the brokerage firms supporting financial advisors and has the mission to ensure investor confidence and market integrity, can the NASD be far behind in ensuring investor confidence by finally acknowledging the fiduciary responsibility of the financial advisor?

The new rules (204A1 and related rule amendments under the Investment Advisor's Act of 1940) proposed by the SEC are intended to reinforce the fiduciary principles that govern the advisor. Each regulated investment advisory firm that engages their counsel for a fee is required to have a code of ethics, which must minimally include:

- Code of Conduct. The business conduct of all the advisor's supervised persons must reflect the advisor's fiduciary responsibility. There must be written acknowledgement of all supervised persons that they have received a copy of the advisor's Code of Ethics.
- Federal Securities Law Compliance. All the advisor's supervised persons are required to comply with applicable federal securities laws.
- Confidentiality. Disclosure of material non-public information about the advisor's recommendations and client securities holdings and transactions are prohibited unless there is a designated person authorized for access on a "need-to-know" basis.
- Personal Securities Reporting. Supervised persons with authorized access to confidential information must report their personal securities holdings and transactions, including transactions in mutual funds advised by the advisor or affiliate.
- Pre-Authorization of Transactions. Persons with authorized access must clear personal investments in IPOs and limited private offerings.
- Violation Reporting. Supervised persons must promptly report any violations of the advisor's code of ethics to the firm's compliance officer or the appropriate designated person.

The SEC has long acknowledged the fiduciary responsibility of financial advisors and in proposing this code of conduct, the SEC ensures a higher level of conduct and institutionalizes a higher level of counsel that greatly elevates the role of the advisor. Unless the NASD answers in-kind, the SEC has bifurcated the financial services industry into two tiers of financial advisors. One tier of advisors, working under the jurisdiction of the SEC, acknowledges fiduciary responsibility and actively endeavors to add value. The other tier of advisors, working under the jurisdiction of the NASD, insulates themselves from fiduciary responsibility and limits their role to trade execution and commission sales. This divergence is solely based on the different roles the SEC and the NASD envision the advisor playing. The SEC is clearly more aligned with financial advisors who are ethically compelled by principle to fulfill their fiduciary obligations to their clients and who engage their counsel for a fee.

The NASD is a non-profit, self-regulatory organization whose brokerage-firm members establish the rules that govern the behavior of every brokerage firm doing business in the U.S. Its mission is to ensure market integrity and investor confidence. The NASD has never been able to develop consensus among its members to formally acknowledge the fiduciary responsibility of the financial advisor. Yet, empirical and anecdotal data strongly suggests investor confidence continues to suffer (as does the financial advisor) from there being no institutionalized support within the brokerage industry for financial advisors to fulfill their fiduciary responsibility. From a public policy standpoint, the NASD cannot view investor confidence as being secondary in importance to market integrity. It is simply a matter of the NASD membership, as a self-regulatory organization, not having the will to assume fiduciary responsibility for the counsel its member firm advisors render. This is not irrational, as acknowledgement of a fiduciary responsibility would indeed be highly disruptive and would radically transform the brokerage industry. Yet, by the NASD membership not acknowledging the fiduciary responsibility of its financial advisors, it appears the NASD membership is placing the self-interests of the brokerage industry ahead of that of the best interests of the investor. Clearly, a loss in consumer confidence has occurred, which places the NASD's mission and public purpose at odds with its membership.

This conundrum is virtually impossible for the NASD to manage, as the limitation of a self-regulatory organization is that it requires its members to agree to be regulated and to coalesce behind innovation, even if it is required by public policy (UPIA, ERISA, UMIFA, UMPERS). It is difficult for the NASD to successfully champion a highly disruptive innovation such as the acknowledgement of fiduciary responsibility that is consistent with public policy, because the NASD staff serves at the pleasure of its membership. In advancing such a disruptive innovation, the staff's tenure would be in jeopardy. The limitation of a self-regulatory organization is that is presumes selfless leadership which, as a practice, is never exercised. Witness the NASD on the question of the fiduciary responsibility of financial advisors when the self-interest of the NASD's brokerage firm constituency is in conflict with both public policy and the investor's best interest.

IT IS DIFFICULT FOR THE NASD TO SUCCESSFULLY CHAMPION A HIGHLY DISRUPTIVE INNOVATION SUCH AS THE ACKNOWLEDGEMENT OF FIDUCIARY RESPONSIBILITY THAT IS CONSISTENT WITH PUBLIC POLICY, BECAUSE THE NASD STAFF SERVES AT THE PLEASURE OF ITS MEMBERSHIP

The NASD can only advance what its membership is willing to embrace, but innovation never starts with a plurality. The entire NASD constituency of member firms does not have to acknowledge fiduciary responsibility and institutionalize the support necessary for their advisors to add value. Only a few firms, like Nashville-based PowellJohnson, need to see the enormous opportunity to reorder the industry's rankings by acknowledging fiduciary responsibility and supporting the financial advisor in their efforts to add value. If nature takes its course and success breeds success, the industry will evolve accordingly.

If it is true, all investors want value to be added and the transparency of the internet is making it clear to the investor whether value is being added, then it is inevitable that the NASD's brokerage firm constituency (and certainly the industry's top advisors) must acknowledge fiduciary responsibility in order to retain their most important and lucrative client relationships. But the wheels of progress move slowly. If we are waiting for consensus within the NASD, it may well be among the last to support innovation rather than the first. Today, there are tens of thousands of financial advisors who want to do the right thing. How do we accelerate institutional support for acknowledging fiduciary responsibility so that the financial advisor can benefit from their firm's institutionalized support in adding value and fulfilling fiduciary responsibility?

For those of us who care about the financial advisor, their counsel and our clients' best interests, there are at least two things we can do to accelerate industry-wide acceptance of the fiduciary responsibilities of financial advisors. In order for the member firms of the NASD to embrace this innovation, we must (1) reduce the brokerage industry's fear of fiduciary liability and (2) make innovation synonymous with a firm's competitive market stature, thus making innovation not only good for enhancing the counsel the advisor provides but good for business by enhancing the firm's earnings, margin and multiple. Only by the brokerage firm constituency of the NASD independently coming to the conclusion that it is in their best interest to innovate will innovation occur. Thus, the case must be made that the new advice business model built upon acknowledging fiduciary responsibility is a dynamic means to build and grow revenues and assets, which will super-

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charge their financial (earnings, margin, multiple) performance. It is a unique American trait that through innovation, massive gains in productivity (faster, better, cheaper) are achieved. Through innovation in process and technology, we take the financial advisor far beyond what is humanly possible in adding value for our clients.

Mitigating Fear

Ten years ago, before the use of the internet became so pervasive, the brokerage industry had every reason to view the six financial service investment processes (asset/liability study, investment policy, strategic asset allocation, manager search and selection, performance monitor and tactical asset allocation), implicit in advisors fulfilling their 97 mandated fiduciary responsibilities, as being a most daunting task to execute. Yet, today that is simply not the case. Eighty percent of fiduciary responsibility is disclosure and reporting, which can be readily automated. Today, the industry can easily create an automated expert system that would empower every financial advisor to address and manage the full range of investment and administrative values as required by regulatory mandate. By virtue of financial advisors working within their firm's investment process, they would automatically be fulfilling their fiduciary obligations. The 20% of our fiduciary responsibilities that require skill to manage (particularly portfolio construction/management) is readily manageable through post-modern portfolio theory tools utilizing real-time information and your firm's proprietary investment methodology that, in effect, constitutes tactical asset allocation. This is taking innovation to its logical conclusion, using advanced technology and time-tested, proven best practices now being executed at the very high end of the market where fiduciary responsibility is viewed more seriously. The technology exists, and there are advisors who are executing at this level (see "How Are Top Advisors Growing Their Business in a Difficult Market," *Senior Consultant,* April 2003, http://www.SrConsultant.com/Articles/2003-04-Top-Advisors-Grow.pdf). There is a convergence of market forces that are compelling advisors to acknowledge fiduciary responsibility. The time has come for the industry to institutionalize the processes and technology necessary for the advisor to add value and fulfill their fiduciary responsibility.

Because fiduciary responsibility has not been acknowledged within the brokerage industry, very few advisors and supporting firms understand what is required of them in addressing and managing the full range of investment and administrative values required by regulatory mandate. As a consequence, our industry's leading financial advisors have had to take the personal initiative to develop the processes, technology, and division of labor within their practices necessary to add value and fulfill their fiduciary responsibility. These leading advisors have a far better understanding of high level counsel than our industry's leading financial services firms.

AS A CONSEQUENCE, OUR INDUSTRY'S LEADING FINANCIAL ADVISORS HAVE HAD TO TAKE THE PERSONAL INITIATIVE TO DEVELOP THE PROCESSES, TECHNOLOGY, AND DIVISION OF LABOR WITHIN THEIR PRACTICES NECESSARY TO ADD VALUE AND FULFILL THEIR FIDUCIARY RESPONSIBILITY

Last year our industry's most accomplished advisors (Guy Cumbie, past president of the FPA; Harold Evensky, past chairman of the CFP Standard's Board; Jim Pupillio, past president of the ICIMC and past president of APIC) along with leading practitioners (Bob Rowe, Dick Smith, David Perkins, Hugh Anderson, Rich Todd, Robby Hazzard and Vince Birley) who average well over $1 billion under advisement, worked with the Center for Fiduciary Studies, The Society of Senior Consultants, the AICPA, Dalbar, and leading advisor support organizations (Placemark, Investment Scorecard, Prima Capital, PPCA, Rowe Decision Analytics, Bullrun Financial, Klein Decision, Sungard, Market Street Advisors) on the high net worth standards initiative to define the breadth and depth of counsel required of the advisor by regulatory mandate. The objective was to foster the development of innovative technology which would reduce the labor intensity of high level counsel and elevate the role and counsel of the financial advisor. This invaluable research will be published next month. Its parallel Technology Working Document, which is a technological blueprint for the processes and technology necessary to empower the financial advisor to add value and fulfill our fiduciary responsibilities, will be published in April. With these documents in the public domain, selflessly created by our industry's top professionals, the complexities, mysteries and myths of fiduciary responsibility are greatly diffused. In essence, account executive excellence is increasingly becoming a matter of choice for the financial advisor. With the SEC now holding advisors to a fiduciary status, it now becomes a choice of which firms provide the advisor with the most support in the fulfillment of their fiduciary responsibility through the engagement of their professional investment and administrative counsel for an ongoing advisory fee.

Using the Center for Fiduciary Studies' definitive research citing case law, statute and regulatory opinion letters as its base point, the High Net Worth Standards Initiative will make it clear to our leading brokerage firms that 80% of fiduciary responsibility deals with disclosure and reporting that can be readily automated. In this day and age of transparency, the High Net Worth Standards Initiative will establish that none of what is required is particularly difficult. It is just when it is all aggregated that it becomes daunting because of all the detail that must be managed. The point of technology is to automate mechanical considerations so high value skill can come to bear on values and considerations that require skill to manage. Even the high value added considerations like investment policy (Rowe Decision Analytics/Klein Decisions), manager search and selection (Prima Capital, PPCA), monitoring/reporting

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(Investment Scorecard, Bullrun Financial, Market Street Advisors, Sungard), and tactical asset allocation (Rowpyn, Quantitative Analytics, Dynaporte) can be readily resolved by outsourced solutions that make the advisor look brilliant and empowers them to do things that otherwise would not be possible.

The findings of the High Net Work Standards Initiative diffuse the irrational fear of brokerage firms ignoring fiduciary responsibility. With the transparency of the internet, the time has come for the industry to manage fiduciary liability, not to deny or ignore it. Today it is easier, better and cheaper to manage fiduciary responsibility than to ignore it, as in this litigious age, enterprising litigators will find their way to the fiduciary responsibility of the financial advisor. Without the support of their firms, most financial advisors are sitting ducks. Brokerage firms should be fearful of fiduciary responsibility, but not based on maintaining their advisors offer no advice, but based on their not offering any institutionalized support in managing fiduciary responsibility. It has been said that the brokerage industry is hiding behind the letter of the law to escape the higher demands of the spirit of the law. If it comes to litigation in support of public policy, the best interests of the consumer will trump the self-interests of the brokerage industry. This would be a lose-lose situation for the brokerage industry and a scandal to end all scandals, if the industry does not take a fresh look at fiduciary responsibility.

A Compelling Business Case

Given commission brokerage rates have declined 60% over the past decade and over 90% since 1972 (from 40¢ a share to 3¢ a share today), a commission broker has to be ten times more productive today than in 1972 just to maintain their earnings of 30 years ago. Today, a commission broker has to be 2½ times more productive to maintain their earnings of a decade ago. Large institutional firms like Fidelity are planning to be very profitable, operating in a zero trading cost environment. There is very high interest on the part of our industry's most successful financial advisors to move from commission sales to engaging their counsel for an on-going advisory fee. The transparency of the internet is making it painfully clear to the investor that it is not possible to add value in commission sales. If the brokerage industry is listening to the marketplace, it is in its best interest to evolve its business model as quickly as possible from commission sales to fee-based advice.

If the brokerage industry explores fee-based counsel, it will discover is that it is not possible for a fee-based advisor to add value working within a commission brokerage business model, but it is possible for a commission broker to execute trades in the new fee-based advice business model. Because the financial advisor is empowered by process and technology, they can provide an unprecedented level of professional investment and administrative counsel, going far beyond what is otherwise humanly possible. Because the advisor is being leveraged by process and technology, the new advice business model incurs half or less the cost of the old commission brokerage business model, and generates higher earnings and margins. It also commands three times the earnings multiple. By commission brokerage firms moving from a product management organizational structure to a process management organizational structure designed to empower the advisor to add value in each of the ten major market segments (mass, retail, high net worth, ultra high net worth, defined contribution, defined benefit, public funds, profit sharing, foundations and endowments, and Taft Harley) of the individual and institutional investor markets, their financial performance is supercharged, while service to the client is increased exponentially. The benefit to the industry, the advisor and the consumer of the industry fully utilizing the potential of process and technology is truly extraordinary in every way. It simply requires firms to do things differently that may seem radical in an historical context, but the results are radically extraordinary as well. Firms with vision will get it. But for the tens of thousands of advisors who want to add value, it is our collective job to help the industry to see it. It is in the industry's best interest not to just acknowledge fiduciary responsibility, but to do everything in its power to build the support infrastructure necessary to divert as much of its earnings as possible to the new fee-based advice business model with higher earnings, margins and multiple.

There has never been a more exciting time to be in the financial services industry, as firms like PowerJohnson, who sponsored the High Net Worth Standings Initiative, are institutionalizing the support infrastructure necessary for advisors to add value and fulfill their fiduciary responsibility. Very few investors have been exposed to this extraordinary level of counsel, and clients are being won at will. How far behind will the NASD and the brokerage industry remain? No one knows. But until it answers in-kind, the opportunity is unprecedented for enterprising advisors who are ethically compelled to fulfill their fiduciary obligations. ■

Commentary

Due to the passion that we at *Senior Consultant* feel about elevating the advisor's role within the financial services industry, Steve Winks now avails himself to making presentations about the fee-based business model and other related industry topics. For more information and availability, contact Steve Winks at SWinks@SrConsultant.com.

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