

# SENIOR CONSULTANT

The Voice of the Investment Management Consultant

## Countdown to Fiduciary Responsibility: SEC to Hold Advisors To a Fiduciary Standard Starting October 5, 2004

*Stephen C. Winks*

The investing public's trust is difficult to win and easy to lose. SEC chairman, William Donaldson, observed in January, "As fiduciaries, advisors owe their clients more than honesty and good faith. What we are seeing leads me to believe that all too many advisors have been delivering much less." How does the SEC ensure the faith and trust of the investing public in the financial advisor's ability to act in the investor's best interests?

The industry is rife with stories of financial advisors whose professional integrity has compelled them to act in their clients' best interests in fulfilling their fiduciary responsibilities, only to be prohibited by our largest financial services firms from writing investment policy statements, reporting on all the clients' holdings or even acknowledging they are, in fact, rendering investment and administrative counsel. The thinly-veiled secret is that most major financial services firms that support financial advisors have insulated themselves from fiduciary responsibility and deem it a breach of their internal compliance protocol for an advisor to acknowledge their fiduciary obligations. Advisors are actually penalized for acting in their clients' best interests. In order for our industry to evolve into a profession, there must not only be the acknowledgement of the fiduciary responsibility of the financial advisor, but our leading financial institutions must provide the enabling processes, technology and support infrastructure necessary for the financial advisor to fulfill their fiduciary responsibilities.

SEC chairman Donaldson seeks to openly align the best interests of the investor and the advisor with that of the advisor's supporting firm in a way only made possible by a regulatory authority. The public policy promulgated by state and federal legislative bodies is clear as to what is required of financial advisors in

engaging their counsel. In a brilliantly conceived strategy that will ensure the investing public's trust in the financial advisor's counsel, the SEC will start holding advisors and their supporting firms to a fiduciary status, effective October 5, 2004, by requiring a code of ethics from each advisor, that acknowledges their fiduciary responsibility. This simple and elegant solution is the beginning of investment and administrative counsel becoming a profession.

Holding the advisor and their supporting broker/dealer to a fiduciary status fundamentally changes how the industry does business, how it is structured, its

technology and its support infrastructure. It greatly elevates the role and counsel of the advisor from the lowest common denominator of trade execution to the highest common denominator – fulfilling fiduciary responsibility. It changes the industry's business model from trade execution and financial product promotion and distribution to the advisor's management of investment and administrative values. It vastly improves the economics of the industry. By leveraging the financial advisor through process and technology, the industry cuts its cost in half while increasing

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its earnings, margins and multiple, all while empowering the advisor to deliver an unprecedented level of professional investment and administrative counsel. Importantly, unlike just five years ago, today virtually all the processes and technologies necessary to add value exist (see *Senior Consultant*, April 2004, "[Technology Blueprint. Elevating the Advisor's Counsel Beyond the Human Capacity to Reason](http://www.srconsultant.com/Society/TechBlueprint/TechBlueprint1.html)") (<http://www.srconsultant.com/Society/TechBlueprint/TechBlueprint1.html>), which cites the enabling technology by vendor). By virtue of the advisor simply working within the context of an electronically-managed, self-auditing investment process, virtually all



financial advisors are assured of fulfilling their fiduciary responsibilities and addressing and managing the full range of investment and administrative values as required by regulatory mandate. Given the advisor is being held to a fiduciary standard, the advisor cannot expect anything less from their supporting firm(s).

This is an historic opportunity for the industry to elevate the role and counsel of the financial advisor and its professional standing. The acknowledgement of the advisor's fiduciary responsibility is a watershed event every bit as profound as the deregulation of commission brokerage rates from 40¢ per share in the early 70's. If there is fear and trepidation, most of it is unwarranted. The challenge in the financial services industry acknowledging the fiduciary status of its advisors has not been in knowing what to do or how to do it, but in the will to execute. And now the will to execute has been brilliantly resolved by regulatory mandate. There will be dislocation, which is true of all innovation, but the elevation of the role, status and counsel of the financial advisor and the value they add will be unprecedented. The voice of the financial advisor will be heard as never before, as the SEC has made it politically tenable for the advisor to demand more from their supporting firms and professional organizations. The fear that some advisors will be left behind – and many will – is no longer valid, as it puts the self-importance/interests of advisor support firms, trade associations and the industry's least able advisors ahead of the clients' best interests. If advisors are enabled to fulfill their fiduciary obligations but do not, then their supporting broker/dealer should have some rationale that they are serving the investing public. This gives new meaning to "acting in the clients' best interests," as in holding the advisor and their supporting firm to a fiduciary standard unambiguously tied to UPIA, ERISA, UMIFA and UMPERS. There is now an objective quantifiable measure to affirm whether an advisor and their supporting firm is, in fact, acting in the client's best interest. This is an important step in establishing the professional standing of the advisor and their firm. Yet, it is also threatening to many of our industry's trade associations' which have largely subjective criteria for membership. This has led SEC chairman Donaldson to conclude that integrity,

honesty and good faith alone are no longer sufficient to assure the investors' best interests are being served. A much more specific, quantifiable and measurable criteria of fiduciary responsibility is required for an advisor to act in their clients' best interests.

Consider the comments of the industry's leading trade associations on holding the advisor to a fiduciary status. With the exception of the AICPA and AIMR, there is only conceptual support in principle for a fiduciary standard. In practice, there is little operational support for language in a code of ethics specifically defining fiduciary responsibilities and procedures, as cited in UPIA, ERISA, UMPERS and UMIFA. This position essentially renders the state and federal legislative

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initiatives irrelevant to defining the fiduciary responsibilities of the financial advisor. Each association prefers their own code of ethics, which often does not even reference fiduciary responsibility. As you can see from the following comments, the self-interests of these trade associations are clearly being put ahead of the best interests of the investor. This is why the leadership of SEC chairman Donaldson is so important.

The Financial Planning Association (FPA) does not express support for fiduciary standards. Instead, the FPA expresses support for its own FPA code of ethics and explains the proposed SEC code of ethics is not necessary because it "duplicates" that of the FPA's code. The FPA states: "We do not believe that CFP certificants should be required to adopt redundant provisions in the code of ethics they would be required to adopt under the proposed rule. We propose instead that CFP certificants be permitted to incorporate by reference the CFP board code of ethics and include in the SEC-

required codes only those provisions that do not have an analogue in the CFP board code of ethics." The FPA misses the point. Nowhere in their 1-page, 7-principles code of ethics is there a reference to fiduciary responsibility. This is precisely what the SEC is resolving in requiring a code of ethics from each advisor that acknowledges their fiduciary status. In the words of SEC chairman Donaldson, "Honesty and good faith are not enough." There are very specific responsibilities required in a CFP certificant fulfilling their fiduciary responsibilities that go far beyond the FPA code of ethics. By extension, a CFP certification does not assure a client that the advisor's fiduciary responsibilities are being fulfilled, just that the CFP is acting in a fiduciary capacity.

The Investment Counsel Association of America (ICAA) expresses conceptual support for fiduciary responsibilities, noting that it has "endorsed standards emphasizing an investment advisor's fiduciary duty." Also, it notes it is currently developing a model code of ethics that, among other purposes, seeks to "help educate advisory personnel of their fiduciary responsibilities." However, the Association opposes the SEC suggesting "particular standards of conduct" and urges it to instead adopt a "flexible approach" that allows individual members of the profession to "tailor their codes of ethics to accommodate their business activity." Yet, does not this very flexibility eviscerate the concept of a fiduciary standard by accommodating the lowest common denominator of commission sales where there may legitimately be no fiduciary responsibility associated with trade execution services? The point is: If there is advice implied in commission sales, regardless of whether one has discretionary control of the client's assets or not, the advisor and their supporting firm are subject to a fiduciary standard, and there is no need for flexibility or accommodation. Either advice is rendered or it's not. And if so, then advisors are held to an unambiguous fiduciary standard. By the SEC requiring advisors to declare their fiduciary status in their own personal code of ethics, there is no longer a question of whether they are providing investment and administrative counsel or simply engaged in the clerical function of trade execution. This confusion in advisor roles has



crippled the evolution of the support provided by financial services firms to its advisors. Rather than the industry prohibiting advisors from acknowledging their fiduciary responsibilities, the SEC has created a mechanism that encourages advisors and their supporting firms to acknowledge their fiduciary status.

The Investment Management Consultants Association (IMCA) states that it “promotes the highest standards of ethical conduct in the investment management consulting profession and believes that advisors should be required to adopt ‘standards of practice’ that set forth in greater detail (beyond a code of ethics), a set of common ideals covering the professional conduct of advisory personnel. This structure emphasizes and reinforces fiduciary obligations while also informing, without overwhelming, investors of the integrity and service they have a right to expect from professional investment advisors.” IMCA acknowledges fiduciary responsibility in its practice standards, but not in its code of ethics. It considers its practice standards as ideals to which advisors should strive, rather than definitive unambiguous criteria that constitutes advice. Again, in the words of SEC chairman Donaldson, “Honesty, integrity and good faith are commendable, but are no substitute for the actual execution of a fiduciary standard.”

The CFP Standards Board “strongly supports the Commissions’ proposal calling for an investment advisor code of ethics.” In its discussion of “Code of Ethics and Professional Responsibility” and “Standards of Conduct and Compliance with Laws,” there is a detailed discussion of the history and effectiveness of the CFP Board’s code of ethics and “practice standards.” It is noted, when CFPs agree to abide by its code: “Certificants have agreed to provide personal financial planning in the client’s best interest and to act in accordance with the highest ethical and professional standards for the practice of financial planning.” But the CFP Standards Board misses the point that the practice of financial planning is not synonymous with the fulfillment of fiduciary responsibility and the unambiguous fiduciary standard set forth in UPIA, ERISA, UMIFA and UMPERS is required and enforced by regulatory mandates. There is no regulatory-enforced standard for financial planning. Thus,

fiduciary responsibility has a far higher standard for compliance, which is why it is important that all advisors acknowledge a fiduciary standard.

The common theme of these trade associates is their support, in principle, of a fiduciary standard, but little support in holding their constituency of advisors accountable in executing a level of counsel consistent with a fiduciary standard. Though holding an advisor to a fiduciary standard is not a condition of trade association membership, the advisors’ acknowledgement of their fiduciary status greatly elevates the importance of the training and education mission of our industry’s leading trade associations.

The financial services industry’s culture, structure, technology and infrastructure are

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geared to its historical role of trade execution services and product promotion and distribution. Traditionally, advisors do not get paid unless they sell something. Yet, by definition, it is not possible for an advisor to add value through a series of disjointed, unrelated transactions we know as commission sales. There simply is no mechanism in place for the commission salesperson to know whether their recommendation improved the overall return on the client’s holdings as a whole, reduced their risk or enhanced the tax efficiency, liquidity and cost structure of the client’s portfolio as a whole. Because of breakthrough technological innovation, facilitating account transparency and the free flow of client permissioned information among custodians, it is possible today for every financial advisor to provide an unprecedented level of professional investment and administrative counsel that is in compliance with the highest fiduciary stan-

dards. With the SEC requiring advisors to acknowledge their fiduciary status, this possibility becomes a reality. And, by extension, the role, the status and the counsel of the financial advisor is greatly elevated. The SEC has brilliantly facilitated investment and administrative counsel emerging as a profession with equal fiduciary status to other professions entailing trust.

Some would argue that the advisors acknowledgement of fiduciary status is meaningless, as fiduciary responsibility can be deemed anything one wants it to be, as has been the case in the recent past. Clearly, the SEC is not defining fiduciary responsibility, it is just requiring acknowledgement of the advisor’s fiduciary status; but the Foundation of Fiduciary Studies has authoritatively defined fiduciary responsibility, citing statute, case law and regulatory opinion letters. [The High Net Worth Standards Initiative](http://www.SrConsultant.com/Articles/2004-03-What-Is-Advice.pdf) (http://www.SrConsultant.com/Articles/2004-03-What-Is-Advice.pdf) comprised of our industry’s leading advisors and technical experts, has gone further and established best practices defining the depth of our advice to complement the Foundation of Fiduciary Studies’ definition of the breadth of our advice. Smith Barney has engaged the expert counsel of the Foundation for Fiduciary Studies to create an even more definitive definition of best practices based on the

Foundation’s research of fiduciary responsibility. There is no longer the issue that fiduciary responsibility has not been defined. Today, the fear of litigation and fiduciary liability can no longer be mitigated by the denial of fiduciary status, as that will only assure litigation. In this new regulatory environment, the only protection from fiduciary liability is the advisor’s acknowledgement of fiduciary status and the advisor’s supporting firm providing the support necessary for the advisor to address and manage the full range of investment and administrative values as required by regulatory mandate/best practices. Today, several technology firms are working on creating electronic wizards to automate the 240+ functions necessary to fulfill fiduciary responsibility in a self-audited electronic investment process. Our industry’s largest advisor support firms with the most resources will have the most incentive to comply because they are the biggest enforce-

ment targets. In a very short period of time, between now and October 5, advisor support organizations will have to go from the discouragement and/or prohibition of advisors conducting asset/liability studies, creating investment policy statements, monitoring the performance of a client's holdings and acknowledging fiduciary status, to supporting and rewarding such activities.

A few firms, like Smith Barney, are ahead of schedule. They are working with the Foundation of Fiduciary Studies to define best practices in fulfilling fiduciary responsibility. Through the leadership of Paul Hatch, they will have investment policy capability in place by September, and through the leadership of Peter Cieszko, Smith Barney Asset Management has emerged as a leading advocate of connectivity and the free flow of client permissioned data among custodians. The connectivity issue drops the cost of data aggregation so that it becomes cost-effective to conduct an asset/liability study and to provide continuous, comprehensive counsel in real-time, as implied by regulatory mandate.

Advisor support firms that are not ready to support the fiduciary status of their advisors can easily and inexpensively gain access to web-based processes and technologies necessary for their advisors to fulfill their fiduciary obligations. The only thing keeping you from having institutional-quality investment policy statement capability (myinvestmentpolicy.com) with legal opinions on your desk tomorrow morning is your firm's vision and initiative. The same is true for custom benchmarks (Klein Decision) for each of your clients, which is half the work in portfolio construction. The same is true for AIMR-compliant aggregated account data on all your clients holdings from multiple custodians (Investment ScoreCard). The web-based enabling processes and technologies necessary to empower the financial advisor to address and manage the full range of investment and administrative values, required by regulatory mandate, are out there. The opportunity for the adoption of breakthrough technological innovation has never been greater. It is also true, with the SEC requiring advisors to acknowledge their fiduciary status, the obligation and responsibility of firms supporting financial advisors, as well, has never been greater.

SEC chairman Donaldson, in concert with the entire regulatory mechanism within which he works, has brilliantly conceived a simple and elegant solution to facilitate a much higher level of advisor accountability and counsel: The acknowledgement of the advisor's fiduciary status. Starting October 5, Gene Gonkley and his SEC examiners will have some very interesting questions on documenting and evidencing of the prudent process used by the advisors in engaging their counsel, which are incumbent upon all advisor support organiza-

tions to resolve. Here are just a few that might merit your consideration.

- Has the advisor's supporting firm empowered the advisor to conduct an asset/liability study of all the client's holdings before investment recommendations are made?
- Has the advisor's supporting firm empowered the advisor to create a statement of investment policy for each client which governs the management of the client's holdings, establishing the role and responsibility of all parties, delineating the prudent process used, performance metrics and benchmarks and specific investor instructions necessary to fulfill fiduciary responsibility?
- Has the advisor's supporting firm documented the prudent process used in evaluating and selecting the investment managers which were engaged?
- Has the advisor's supporting firm empowered the financial advisor with the methodology and processes so that each investor understands his risk, his goals and objectives and the likelihood of his investment strategy and associated asset allocation achieving its objectives?
- Has the advisor's supporting firm limited the investment alternatives considered, disclosed all potential conflicts of interest and all sources of compensation derived from the engagement of their counsel with each client?
- Has the advisor's supporting firm supported the DTCC initiative that would facilitate the free flow of client permissioned real-time information among custodians?
- Has the advisor's supporting firm provided the advisor with the resources and real-time analytical tools that would enable their clients to receive continuous, comprehensive counsel, as implied by regulatory mandate?
- Has the advisor's supporting firm provided the research and investment methodology which would facilitate tactical portfolio adjustments based on more current information than recent historical quarterly data?

All these questions should be answered by October 5, 2004; and as you can see, though honesty, integrity, and good faith are important, there is a far higher standard for counsel coming that greatly elevates the advisor, the industry and their professional standing. The investing public's trust is indeed difficult to win and easy to lose. The SEC's leadership should be applauded, as only through their actions as a regulatory authority can the industry find the will to elevate the role and counsel of the financial advisor. With your support in being good stewards of the public's trust, the role and counsel of the financial advisor will be greatly elevated. ■

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