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SENIOR CONSULTANT
The Voice of the Investment Management Consultant

# It Is Time To Overhaul Our Compliance Protocol

*Stephen C. Winks*

On January 7, 2005, when the SEC requires advisors to declare their fiduciary status, every advisor in the industry will want to assure their clients they are acting in a fiduciary capacity. Yet, for the advisor to put their clients' interests ahead of their own and that of their supporting firms, and to fulfill their fiduciary obligations, the advisor would actually be violating the internal compliance protocol of their supporting NASD member firm. As contradictory as it may seem, in advisors doing the right thing and acknowledging their fiduciary responsibilities, they would actually be subject to disciplinary action, branded as a compliance problem and possibly terminated by their supporting firm.

Today, the vast majority of us work in a legal construct that insulates our NASD supporting firm from incurring any fiduciary liability associated with our providing investment advice. Yet, in our supporting firms minimizing their fiduciary liability, our role and counsel as an advisor is also minimized, certainly precluding us from declaring our fiduciary status. Essentially, our role as an advisor, working within a NASD member firm, is to make the investor aware of their investment alternatives. It is up to each investor to determine ... on their own ... the investment merit of our recommendations, regardless of how limited their investment knowledge and experience may be. With no investment advice being acknowledged, implied or rendered, and our role and that of our supporting firm being limited to trade execution, there is no fiduciary liability, as there is no investment advice being provided. While this legal construct has worked beautifully for our supporting firms, it does not work well for either the investor or the advisor. A caveat emptor ("buyer beware") relationship exists between the client and the advisor. But more importantly, our industry's leading financial services institutions that support the vast majority of the industry's advisors, have been crippled in their efforts to provide the enabling infrastructure to support the advisor's declaration of fiduciary status. This is certainly counter to the founding premise of the NASD – to ensure the investing public's confidence and trust – which was the legislative intent of making the NASD our industry's self-regulatory organization. The NASD member firm's legal construct within which all 658,000 licensed advisors must work, actually precludes advisors from doing the right thing (putting the investor's interest ahead of their own) and from acting in a fiduciary capacity. It actually penalizes those advisors who try. Clearly, the time has come to overhaul this longstanding compliance protocol. The self-interests of NASD member firms are being put ahead of the best interests of the investor and the advisor. There must be a compliance protocol within NASD member firms that allows and even encourages advisors to declare their fiduciary status. If not, every advisor working within a NASD member firm is at a material disadvantage to SEC-registered investment advisors who are capable and can act in a fiduciary capacity. Trillions of dollars will change hands over the next 24 months, just based on the simple premise of whether advisors can act in a fiduciary capacity. It is in the enlightened self-interests of NASD member firms to empower the advisors they support, to fulfill their fiduciary obligations.

> **THE SELF-INTERESTS OF NASD MEMBER FIRMS ARE BEING PUT AHEAD OF THE BEST INTERESTS OF THE INVESTOR AND THE ADVISOR**

Compliance has historically been viewed as a means by which NASD member firms stay out of trouble. There is very little latitude to negotiate, very little to debate, and the presumption is "just don't ask." Yet, this compliance mechanism is both wise and necessary in a commission sales culture where the focus is on the promise of extraordinary returns that are so difficult to achieve and virtually impossible to sustain. If a commission sales organization were to be held to a fiduciary standard without access to the necessary resources, there is good reason for our supporting firms to fear the fiduciary liability that would surely follow. There is no means to direct or manage thousands of unprepared advisors in rendering investment advice. Just as we must work within a legal construct today that neither acknowledges our fiduciary responsibilities nor our rendering of investment advice, the industry's challenge is to create an equally tight legal construct that

acknowledges our fiduciary responsibilities and empowers us to address and manage the full range of investment and administrative values required. This business model would greatly elevate the role and counsel of the financial advisor to a professional standard. It would ensure the trust and confidence of the investing public, as the NASD is charged to reduce fiduciary liability and compliance risk to virtually zero.[1] But most importantly, this new business model would provide a much lower cost structure for our supporting firms, with much higher earnings, margins and multiples than can be ascribed to the present commission sales business model. Through the use of advanced processes and technology, we would greatly leverage the level of investment and administrative counsel we are able to provide, taking us far beyond what is humanly possible, if we were to be left to our own devices. Virtually, all the elements of this new legal construct exist, and virtually all enterprising advisors could quickly articulate and deliver a much higher level of investment and administrative counsel. Through a highly structured investment process and expert systems, the advisor would be assured, by virtue or working within this process/legal construct that their fiduciary responsibilities are being fulfilled. This is just as certain as it is today, that by virtue of working within the legal construct of our supporting NASD member firms, no investment advice is rendered and thus, the advisor has no fiduciary obligation. Rather than reduce the role and counsel of the advisor to the lowest common denominator of trade execution, why not elevate the role and counsel of the advisor to the highest common denominator of fiduciary counsel?

There are those who would argue that advisors are not capable of fiduciary counsel. This is a false argument. If advisors are provided the enabling resources, fiduciary counsel could be readily provided. The fact that our supporting firms have been crippled in providing the resources necessary to support fiduciary counsel by virtue of their choosing not to acknowledge our fiduciary responsibilities is simply an excuse and certainly not a reason, especially when the enabling resources exist.

**RATHER THAN REDUCE THE ROLE AND COUNSEL OF THE ADVISOR TO THE LOWEST COMMON DENOMINATOR OF TRADE EXECUTION, WHY NOT ELEVATE THE ROLE AND COUNSEL OF THE ADVISOR TO THE HIGHEST COMMON DENOMINATOR OF FIDUCIARY COUNSEL?**

There is not an enterprising advisor in the industry who is not ready, willing and able to take advantage of the trillions of dollars that will change hands over the next 24 months, based on whether a prospective client's present advisor is acting in the client's best interests by acknowledging their fiduciary status. Today, if you are supported by a NASD member firm and do not have special dispensation to declare fiduciary status, virtually none of your clients are safe in the emerging environment. You simply cannot respond in-kind.

How secure are your clients? Today, virtually every enterprising advisor in the industry, including yourself, is capable of asking several compelling questions that will readily put every account into play. How would you respond if a highly respected advisor would query you?

*Mr. Prospective Client, tell me, is your present advisor acting in a fiduciary capacity that requires them to put your interests ahead of their own and that of their supporting firm? If so, how would they know and how would they assure you? Can their counsel be audited back to case law, statue, regulatory opinion letters and best practices so you are assured that you both can know they are acting in a fiduciary capacity?*

*Here are a few questions that will help you know, Mr. Prospect, if your advisor is acting in a fiduciary capacity. Can your advisor report to you the actual return you have achieved on all your holdings to include those not custodied at their supporting firm? If not, and it is likely they cannot, it is not possible for them to determine whether their recommendations improved overall portfolio returns, reduced risk or enhanced the tax efficiency, liquidity and cost structure of your holdings as a whole. Essentially, it is not possible for your present advisor to add value.*

*Does your advisor talk about risk? Do you know if you are taking 150% of the market's risk for 50% of its return?*

*Does your advisor talk about the cost structure of your investment portfolio? Do you know that mutual funds are three times more expensive than managed accounts and that managed account are three times more expensive than folios, ETFS, and overlay management?*

*Does your advisor know whether your holdings are structured in an income and estate tax efficient manner, and how their recommendations would affect your tax strategy? This is the second most important decision in executing an investment strategy.*

*Does your advisor explain the trade-off between tax efficiency and liquidity, cost structure and investment performance, so that to resolve a tax problem, they don't create other more serious problems?*

*Does your advisor have real-time access to your holdings and provide continuous, comprehensive counsel as required, or do you have to wait weeks after the end of a quarter, after it is too late to do anything, to discover how your investments are fairing?*

The questions could go on and on, but clearly fiduciary responsibility is a rich vein to mine. Clearly, from a sales and marketing standpoint, advisors are highly capable of winning trillions of dollars in business over the next 24 months, based on whether a prospective client's existing advisor is acting in a fiduciary capacity. The only thing missing is the supporting resources for advisors to fulfill the promise of fiduciary counsel.

The supporting resources required are easily within the direct grasp of the advisor and certainly within the direct grasp of our supporting firms. There are essentially six prudent processes required that encompass at least 240 investment and administrative values (that can be audited back to statute, case law and regula-



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tory opinion letters) that must be managed to fulfill our fiduciary obligations. The six prudent processes are:

1. **Analyze the client's current position into an Asset/Liability Study**, which entails evaluation of all client holdings, contracts, custodians, prudent experts and vendors in the context of their fiduciary responsibilities.
2. **Formalize investment policy**, which defines the role and responsibilities of all parties and delineates the services provided by the advisor.
3. **Asset allocation**, which establishes an investment strategy that can achieve a benchmark return consistent with the client's objectives, risk and timeframe.
4. **Implementation of a timeframe** where custodians, money managers and other prudent experts are engaged on the client's behalf.
5. **Monitor, supervise and report** on holdings, prudent experts and vendors engaged.
6. **Rebalancing/tactical asset allocation** where periodic adjustments in the portfolio are executed, based on formula, evaluation tools or investment methodology.

Each of these six prudent processes entails very specific fiduciary responsibilities. Importantly, experts have built outsourced prudent processes (in which they often even assume fiduciary responsibility) for just about all of the six prudent processes required. So there is little question of whether fiduciary counsel is possible or can be supported; it is a question of whether our supporting firms want to support fiduciary counsel. For enterprising advisors, virtually all these resources provide either direct advisor access or advisor access through intermediaries like an ASTTrust.

For further discussion of each of the six prudent processes and associated resources, consult our Consultant's Toolbox (http://www.srconsultant.com/Toolbox/toolbox.html). Just to name a few resources:

1. Analyze: Center for Fiduciary Studies
2. Investment Policy: Myinvestmentpolicy.com
3. Asset Allocation: $K^4$, Ibbottson, Brinson
4. Implementation: Prima Capital, Green Rock
5. Monitoring: Investment Score Care, PPCA
6. Tactical AA: Rowpyn, Oberuc, Sortino

With direct advisor access to these resources, there should be no problem for NASD member firms finding the resources to build a tight legal construct in which advisors can fulfill their fiduciary obligations. The challenges lie in the firm letting their advisors go and becoming self-sustaining, in the firm materially upgrading their technology and in the firm culturally evolving from a commission brokerage mindset to an advisory mindset. Investment and administrative values must be addressed and managed, rather than investment products being sold. Even more profoundly, in the advisor engaging their professional investment and administrative counsel for an on-going advisory fee, the resulting fiduciary counsel does not require the advisor to even be licensed to sell securities. This circumvents the NASD's intolerance for advisors fulfilling our fiduciary responsibilities. Thus, the ultimate challenge is cultural. Money, ego and status are at stake. The powerful product-management organizational structure of old within the NASD member firms must give way to the more new powerful process-management organizational structure that helps advisors add value for each market segment in which they are focused, whether it be serving individuals or institutions.

The reason why NASD member firms do not want to acknowledge our fiduciary responsibilities and will not adapt their internal compliance protocol to make it possible for their advisors to fulfill their fiduciary responsibilities is not just the avoidance of fiduciary liability. Fiduciary responsibility can be acknowledged and readily managed through a tightly managed legal construct, as we have discussed and illustrated. The processes, procedures and technology are readily available. The fear is not really fiduciary responsibility, fiduciary liability or advisor ability. The fear of the NASD member firm is that fiduciary responsibility will fundamentally change their culture, structure and technology. The trading and product management skill sets that drive the industry today do not translate well into the new, required process-management organizational structure. It would be heresy to postulate within a brokerage firm that the firm of the future will not be a brokerage firm. More than likely, it will be an advisory services firm built around a process that manages trade execution as a cost center. With Charles Schwab envisioning the day when trade execution cost and product access are provided for free, why should the industry continue to be structured around trade execution? The client's best interests are best served by fiduciary counsel, which is not even possible in today's trade execution culture.

The reason why NASD member firms will adapt their compliance protocol and acknowledge our fiduciary status is that the declaration of fiduciary status is important to the client, the SEC requires it and neither care how difficult it is to execute. "Not wanting to" is no longer an acceptable answer. When the marketplace speaks and trillions of dollars change hands based on their best interests being served, it becomes a matter of adapt or perish for both the advisor and their supporting firm. Depending upon your perspective, this is either the best time or the worst time ever to be in the financial services industry, as it is being reordered around fiduciary principles, whether we like it or not. Could it be that Charles Schwab, Fidelity or T.D. Waterhouse – who really see the opportunity – will supercede our major NASD member brokerage firms for market leadership? Maybe it will be Parametric, Placemark, or Smart Leaf? Maybe J.P. Morgan or the AICPA? But with trillions in

**THE CHALLENGES LIE IN THE FIRM LETTING THEIR ADVISORS GO AND BECOMING SELF-SUSTAINING, IN THE FIRM MATERIALLY UPGRADING THEIR TECHNOLOGY AND IN THE FIRM CULTURALLY EVOLVING FROM A COMMISSION BROKERAGE MINDSET TO AN ADVISORY MINDSET**

play, whoever is most responsive to the needs of the investor and the fiduciary advisor will win massive market share and reshape the course of the financial services industry.

Just as it is to a man with a hammer, everything is a nail; to the NASD member firm, everything is a trade. As we enter an environment where trade execution cost will approach zero, you would think there would be visionary leadership to actively embrace fiduciary counsel and recurring fee revenues. Where is the vision and leadership when we need it the most? Why isn't the investor's best interest first and foremost in our minds? Why isn't the NASD interested in the trust and confidence of the investing public as they are so charged to foster? Who is looking after the advisor's best interests?

In today's regulatory environment, we have seen Arthur Anderson not survive an ethical breach of just a few persons. Our industry faces a much bigger, far more pervasive scandal. If advisors within NASD member firms are not permitted to fulfill their fiduciary obligation on January 7, I would not want to be on the wrong side of history. It is time to overhaul our NASD member firms' internal compliance protocol for the good of all concerned, to make it possible for advisors to declare their fiduciary status. ■

## Note:

[1]Investors would sign off on investment policy, their goals and objectives, their performance benchmark and investment strategy. The roles and responsibilities of all parties are clearly delineated. There is total transparency. There is clarity that it is not within the power of any advisor to promise investment performance.

**Notes**


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