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A New Year, A New Profession – Fiduciary Advisors for 2005: How We Get There From Here

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Every financial advisor with substantial assets who is engaging their counsel for a fee and/or who is acting in a fiduciary capacity must decide in 2005 whether they will acknowledge their fiduciary status, and if so, whether the firm that they use for support will subordinate their best interests to that of the investor and advisor. The events that have unfolded in 2004 promise to make 2005 the most eventful and certainly the most important year in the long and storied history of the financial services industry. This has prompted SEC Chairman Donaldson to observe that the financial services industry will see more change over the next three years than it has over the previous 50 years.

Let's review the clarity that 2004 brought to the marketplace that makes 2005 so promising:

- It became clear in 2004, that the SEC will require all SEC-registered investment advisors to declare their fiduciary status, thus interjecting fiduciary status into the competitive dialogue of a highly competitive financial services marketplace.
- It became clear in 2004 that the NASD, the self-regulatory authority of the brokerage industry, has not been vigilant in one of its two primary responsibilities – ensuring the investing public's trust. No NASD-member firm acknowledges the fiduciary responsibilities of their advisors, yet the acknowledgement of fiduciary responsibility is essential to ensuring the investing public's trust. The intolerance of NASD-member firms of fiduciary responsibility is pushing our best and brightest advisors, who are capable of fiduciary counsel, to became fee-based RIAs, to renounce their securities licenses, and/or to find other means from which to fulfill their fiduciary responsibilities, such as forming private trust companies. Without the acknowledgement of our fiduciary obligations, our supporting NASD-member firms are crippled in their ability to support fiduciary counsel.
- It became clear in 2004 that, contrary to their titles and roles, investment advisors actually don't render investment advice. The role and responsibility of the vast majority of the 658,000 advisors supported by NASD-member firms (independent, regional, and wirehouse) is simply to make investors aware of their investment options. Advisors are working within a legal construct where no investment advice is acknowledged, implied or rendered by advisors. It is up to the investor to make their own investment decisions, regardless of how limited their investment knowledge and experience may be. This caveat emptor ("buyer beware") relationship requiring the investor to act as their own investment counsel is the antithesis of the trusted relationship desired and is counter to regulatory intent and public policy.
- It became clear in 2004 with the passage of the Sarbanes Oxley Act, requiring full disclosure and the direct accountability of CEOs, that a new generation of activist state attorney generals will aggressively pursue abuses in the investing public's trust. This effectively removes the "if you don't know, it can't hurt you" approach to product and service offerings and establishes the accountability of the chief executive officer.
- It became clear in 2004 that our most capable advisors within NASD-member firms, who have long worked with clients held to a fiduciary standard and are capable of working in a fiduciary capacity, cannot declare they are acting in a fiduciary capacity. These highly successful advisors cannot assure their clients that they are putting their client's best interest ahead of their own and that of their supporting firms, because it violates their supporting NASD-member firms internal compliance protocol.

THIS HAS PROMPTED SEC CHAIRMAN DONALDSON TO OBSERVE THAT THE FINANCIAL SERVICES INDUSTRY WILL SEE MORE CHANGE OVER THE NEXT THREE YEARS THAN IT HAS OVER THE PREVIOUS 50 YEARS

Our industry's compliance protocol is out of synch with ensuring the investing public's trust.

- It became clear in 2004 that the broker exemption of the Investment Advisers Act of 1940 (that excuses brokers from acknowledging their fiduciary status, when RIAs are not exempted), will be resolved by the SEC, in part because of the FPA's suit of the SEC.
- If the broker exemption stands, advisors within NASD-member firms will likely have to acknowledge to each client with each transaction with prominent language (no small print) that they are not acting in fiduciary capacity, they are simply acting in a commission sales capacity. Of course, every advisor will want to ensure the trust of their clients by acknowledging they are acting in a fiduciary capacity. Ultimately, this bodes well for fiduciary counsel, yet today, the position of NASD-member firms is the disclaimer absolving the NASD-member firm of any fiduciary liability by maintaining that no investment advice is rendered by investment advisors.
- The FPA suit seeking a level playing field between financial planners and brokers (independent, regional, wirehouses) may likely result in financial planners having to register with the SEC (be careful what you pray for, as you may get it) and being held to a fiduciary standard. This will be most welcomed by planners capable of being held to a fiduciary standard.

Whatever tact the SEC may choose, the acknowledgement of fiduciary responsibility and advisors being held to a fiduciary standard will become a reality in 2005. Whether fiduciary status is required by competitive market forces or by regulatory mandate, it makes no difference – the free market will respond and the industry will be forever changed as anticipated by SEC Chairman Donaldson.

- It became clear in 2004 that an ecumenical group of advisors, whether brokers, investment management consultants, CPA's, bankers, financial planners, plan administrators, insurance agents, trust companies or attorneys (DOL, ERISA, and estate) who are acting in a fiduciary capacity, are unified by common fiduciary principles. This disparate group of advisors has much more in common with each other than with their fellow brokers, planners, etc. Thus, we are witnessing the genesis of a new profession of fiduciary advisors. All investors want their advisors to act in their best interests and to be accountable for their recommendations – fiduciary advisors fill that vacuum. There are far more investors who want fiduciary counsel than there are fiduciary advisors, so the marketing implications for fiduciary advisors are great.

It should be clear to advisors – and through the advisor, clear to the investor – that it will not be business as usual in 2005. Convention and status quo is of no assistance in helping advisors to ensure the trust of the investing public. The innovation required, by necessity, will change the culture, structure and technology, as well as the economics of today's business model. The constant is the financial advisor remains the value added, but now even more so. Much more will be required of the advisor and much more will be provided. Through technological innovation, much of the onerous disclosure and reporting detail associated with fiduciary responsibility, that lends itself to automation, will be automated. The advisor's counsel will be elevated far beyond the human three-dimensional capacity to reason. Today's commission brokerage business model, which has changed little fundamentally since the 1840's, is about to be reordered for the next 50 years around fiduciary principles supercharged by advanced technology that brings fiduciary counsel within the reach of all.

IT SHOULD BE CLEAR TO ADVISORS — AND THROUGH THE ADVISOR, CLEAR TO THE INVESTOR — THAT IT WILL NOT BE BUSINESS AS USUAL IN 2005

There are no villains in the industry's lack of responsiveness to fiduciary principles. The industry is simply trying to minimize fiduciary liability and maximize its profit margins, all perfectly sound business objectives. But in doing so, our industry's largest firms have become so devoted to their business model and the legal construct within which we as advisors must work that they are not open to innovation, new approaches and new opportunities. Why change a proven, profitable business model? Harvard Business School professor, Clayton Christensen, observes in his book, *The Innovator's Dilemma,* that large institutions, whether they be wirehouses, trade associations or money managers, have difficulty with innovation, particularly if it is disruptive technology, as it cuts across the grain of status quo and challenges a carefully crafted, refined and honed business model. Of course, the reason why one would challenge a proven and profitable business model, (the proverbial blind spot of our dominant institutions) is that change is in the best interests of the consumer, as it affords a preemptive value proposition and is required by regulatory mandate. Christensen postulates that the mistake our largest institutions predictably make is to attack new opportunities with their existing business models, when a new business model is required. Essentially, they like their present profit margins and love innovation in principle, but only if that means they don't have to change anything. Thus, the benefits of the extraordinary innovations in process and technology that have occurred and will continue to occur do not accrue to either the investor or the advisor. Our dominant institutions can't see their business model evolving because they simply don't want to, yet because of this blind spot, it is highly likely their business model will be preempted by a new and far more powerful advisor value proposition. Christensen notes this is why large institutions fail. The combination of vested self-interests and/or turf-to-protect constitutes a blind spot for our largest organizations that precludes our dominant wirehouses, trade associations, and money managers from deviating from their carefully crafted, refined and honed business models. The need for innovation is clear, but our dominant institutions cannot and will not work against their immediate self-interests to initiate innovation. This is why they will not acknowledge our fiduciary status and reject enabling technology as being disruptive, as by its very

nature, it must be. The best we can hope for as advisors, is that our largest institutions will adapt and adopt.

It is clear that innovation, particularly disruptive innovation, can only occur outside of our largest institutions. The leadership required to literally define fiduciary counsel and to foster the development of the necessary enabling resources, technology and support infrastructure can only come from an ecumenical group of advisors who are now acting in a fiduciary capacity. Whether they are brokers, RIA's, CPA's, planners, attorneys, plan administrators, money managers or trust companies, these fiduciary advisors are unified around common fiduciary principles and have much more in common with other fiduciary advisors than their fellow brokers, planners, etc. If our industry's leading advisors don't act and our supporting firms won't, then are we not culpable in perpetuating the industry's intolerance of fiduciary principles? To the end of filling the industry's leadership vacuum in advancing fiduciary counsel, the Society of Fiduciary Advisors (SFA) is being organized by leading advisors and technical experts. Its mission is to unify an ecumenical group of leading advisors around common fiduciary principles and to make fiduciary liability manageable by (1) defining fiduciary counsel for each major market segment (citing case law, statute, regulatory opinion letters and best practices) and (2) by fostering the development of the enabling processes, technology and technical support necessary for every advisor to more easily fulfill their fiduciary obligations. By present count, there are approximately 240 investment and administrative values that must be addressed and managed in real-time in order for advisors to offer the continuous comprehensive counsel implied by regulatory mandate. Eighty percent of this is disclosure and reporting related that readily lends itself to automation. Why not create the electronic wizards that would remove this onerous administrative burden of manually managing the extraordinary portfolio detail associated with fiduciary responsibility? Why not bring fiduciary counsel within the reach of all advisors?

The Society of Fiduciary Advisors has no turf to protect or self-interests that would skew objectivity or constrain any consideration. It has the latitude to execute and, on behalf of fiduciary advisors, will tackle objectives essential to fiduciary counsel being widely practiced, that are politically and culturally inexpedient to pursue within our largest institutions. The SFA is comprised of fiduciary advisors, like you, so there is no conflict on fiduciary issues that would impede innovation or constrain it to status quo.

There is much work that needs to be done.

1. The SFA will work with the DTCC and the SEC on the development of the protocol necessary to facilitate the free flow of client-permissioned data among custodians. This will greatly reduce the cost and enhance the reliability of aggregated account data, so it is easier for advisors to make investment recommendations in the context of all a client's holdings that makes it literally possible for the advisor to cost effectively add value.
2. The SFA will work with electronic crossing networks to bring V-WAP (volume weighted average pricing), which is considered best execution, directly to the advisor, mitigating conflicts of interest in self-dealing and prohibited transactions in trade execution.
3. Acting on behalf of the advisor, the SFA will seek innovation that will manage trade execution as a cost center, reducing trading cost to free (as envisioned by Charles Schwab) and perhaps even splitting the spread between the bid- and ask-price (now offered by FOLIOfn), achieving pricing better than can be achieved with conventionally accepted best execution.
4. The SFA will help advisors understand how disparate technologies and technical resources work together to power their value proposition and at what asset level is it cost effective for advisors to bring enabling resources, technology and support staff in-house within their practices.
5. The SFA will help advisors understand the three primary divisions of labor within an advisory services practice and will provide training for each track to assure the development of a credentialed labor pool, a professional career path for staff, an extraordinary level of productivity and very attractive operating profit margins.
6. The SFA will seek, on behalf of the advisor, innovations in overlay management, which will drive down the cost of money management and portfolio administration, while greatly enhancing the technical expertise brought to bear in managing values like tax efficiency and cost structure in managing client holdings in real-time on a day-to-day basis.
7. The SFA will provide practice benchmarking to help advisors understand the dynamics of building an advisory services practice based on market segment focus and various levels of assets and revenues at various configurations of technology and staffing.
8. The SFA will build a critical mass of fiduciary advisors by reaching, cultivating and motivating 200,000 advisors each month with its web-based newsletter. This critical mass of fiduciary advisors assures the economic viability of the resources necessary for fiduciary counsel.
9. The SFA will educate the media, major consumer advocacy groups and U.S. Senators and Congressmen on why fiduciary counsel is essential to ensuring the trust of the investing public.
10. The SFA will identify outsourced expert technical resources that can help advisors create a preemptive value proposition in any market segment they wish to compete.
11. The SFA will sponsor conferences that will literally empower advisors and their supporting staff with a preemptive value proposition. Because the SFA is not constrained by hierarchical protocol, culture, corporate politics, self-interests or turf-to-protect, the SFA conferences will offer the richest content and exchange of information within the industry.

THE SOCIETY OF FIDUCIARY ADVISORS HAS NO TURF TO PROTECT OR SELF-INTERESTS THAT WOULD SKEW OBJECTIVITY OR CONSTRAIN ANY CONSIDERATION

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None of the SFA objectives we cite can be achieved today by our leading institutions, constrained by culture or a product management organizational structure and its associated legal construct, which mitigates fiduciary liability but also minimizes the role and counsel of the advisor. The SFA advances fiduciary counsel and a process management organizational structure managed by advisors and/or their supporting firms, which also mitigates fiduciary liability but maximizes the role and counsel of advisors (maximizing the full range of investment and administrative values the advisor addresses and manages, maximizing the advisor's investment counsel and the value they add and maximizing the advisor's professional standing). By fostering innovation not otherwise possible and democratizing access, the SFA is the catalyst for the emergence of a new profession, Fiduciary Advisors, built upon the fiduciary principles required by public policy, statute, regulatory mandate, opinion letters, case law and best practices.

As an industry and as advisors, we cannot wait for the SEC to adjudicate fiduciary principles and establish case law one principle at a time. It would not instill trust in the investing public. It would create an unnecessary adversarial role between advisors and regulators, and the advisor would never win. The SEC has asked for industry leadership and our leading institutions cannot, or will not, respond. It is up to us as advisors who are acting in a fiduciary capacity to unify behind the common fiduciary principles we share and provide the necessary industry leadership, when it is needed. The Society of Fiduciary Advisors will be formally announced on February 1, 2005 at a news conference in Washington, D.C. In attendance will be U.S. Senators and Congressmen, leading consumer advocate groups and key stakeholders interested in ensuring the trust of the investing public.

As you wrestle with declaring your fiduciary status and how you are going to execute your fiduciary obligation, you are not alone. The SFA is being created *by advisors* just like you, *for advisors* just like you who are united by common fiduciary principles. Whether you are working within a large financial services organization, are an independent RIA or are serving clients in a fiduciary capacity, the SFA is the most direct route to foster innovation, to reduce the labor intensity of fiduciary counsel, and to democratize access to enabling resources. If you have the conscience of your convictions, you will have far more in common with other fiduciary advisors than you do with your fellow brokers, planners, etc. By becoming an active member of the SFA, you can accomplish more by working together toward common goals than you can by working alone. In working together as a founding member, you can forge a new profession – Fiduciary Advisors – that promises to reshape the course of the financial services industry around fiduciary principles. It is the right thing to do for the investor, the advisor, the industry. The needs are great, and your leadership is needed. It is a high honor that our generation of advisors has the historic opportunity to see the promise of fiduciary counsel through to its fruition, and you have an important role to play as a founding member of the SFA. Download and submit your membership application (http://www.srconsultant.com/SFA/SFA-Membership-Appl.pdf) and play an important role in this historic opportunity. Through the SFA acting in concert with other fiduciary advisors, it is now within your power to elevate the role and counsel of the financial advisor and reshape the course of the financial services industry around fiduciary principles. ■

Notes

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