

SENIOR CONSULTANT

The Voice of the Investment Management Consultant

New School vs. Old School in Advisor Support: SFA to Foster Institutionalized Support for Fiduciary Counsel

Stephen Winks

In just three weeks, we will experience an industry redefining change that will bring fiduciary counsel into the financial services mainstream and ultimately within the reach of all investors. On April 15th the SEC will rule on the controversial broker exemption to the Investment Advisors Act of 1940, which has exempted brokers from being held to a fiduciary standard. The principle issue is whether the SEC will hold advisors to a fiduciary standard of conduct or whether the SEC will continue to hold the position that advisors are merely acting in a sales capacity and require a disclaimer with each investment transaction (“The Broker Is Not Acting In A Fiduciary Capacity, No Investment Advice Is Being Provided, The Consumer Must Determine Investment Merit On Their Own”).

In any event, today’s highly competitive financial services industry will likely hold the financial advisor to some sort of fiduciary standard, whether they are ready or not. It is not debatable that fiduciary counsel is in the investor’s best interests. Fiduciary counsel is a preemptive value proposition for the advisor, required by state and federally mandated public policy and simply the right thing to do.

A polarizing debate, surely to ensue concerns who is and who isn’t acting in a fiduciary capacity. The yellow pad financial planner who has always put their clients best interests before their own but has not worked within a prudent process has not been fulfilling their fiduciary responsibilities, contrary to what they have believed. Yet the investment management consultant within a major wire house who is working within a prudent process and fulfilling their fiduciary responsibilities cannot declare their fiduciary status because it violates the internal compliance protocol of their NASD member-supporting firm. Are the yellow pad financial planner fulfilling their fiduciary responsibility just because they say so and the wire house consultant not fulfilling their fiduciary responsibility because they can’t? Shouldn’t there be an objective criterion that determines fiduciary status?

The debate over who is acting in a fiduciary capacity simply cannot be won because, if a firm successfully argues their advisors are not acting in a fiduciary capacity and wins the battle, their advisors have lost the war—since their role and counsel would be minimized and limited to only trade execution and providing product access, both which are fast becoming commodities. If an

advisor is not providing investment advice, then they simply cannot possibly add value. Thus, the financial industry is entering an entirely new era of fiduciary counsel where the blind eye turned to this issue in the past, will no longer be unseeing in the future. An entirely different support infrastructure will be required for fiduciary counsel than for traditional commissioned sales.

Certainly every advisor wants to do the right thing and put their clients interests first, but very few advisors have access to a prudent process. By virtue of the industry’s 658,000 advisors not being able to declare their fiduciary status because it is a violation of their supporting NASD member firm’s compliance protocol—

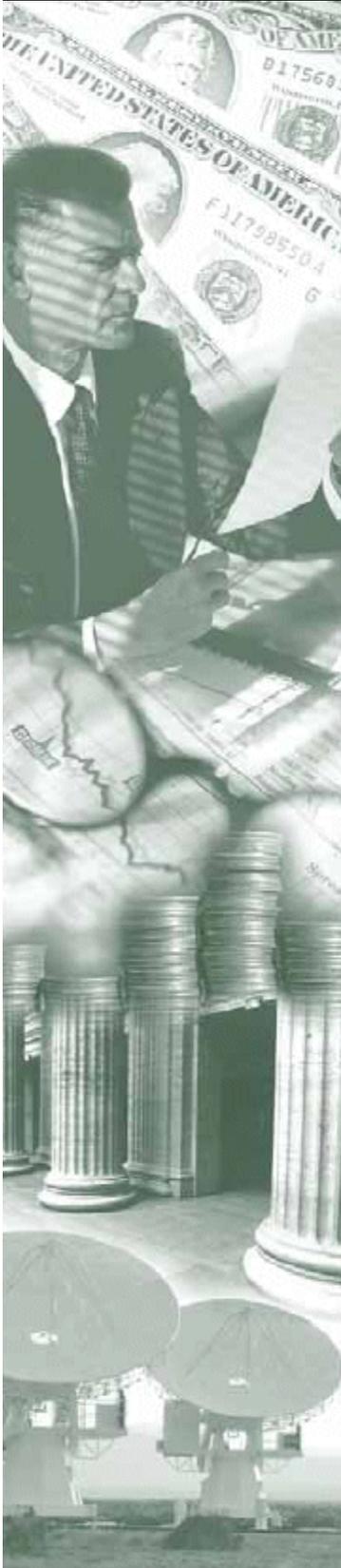
there is no institutionalized support for fiduciary counsel. There are only 65 advisors out of 12,000 at Morgan Stanley who will be able to declare their fiduciary status on April 15th, and similarly small numbers at other major firms.

The industry faces an enormous challenge of conflicting constituencies. Clearly, investors and advisors are well served by the advisor providing

fiduciary counsel, yet the very firms who deny their advisors have fiduciary responsibilities are the very firms the advisors are looking to for help in creating an infrastructure of institutionalized support for fiduciary counsel. Our supporting NASD member firms’ legal construct, within which all advisors must work, maintains that advisors simply make investors aware of the investment alternatives available, with no investment advice implied or rendered.

Further, the investor is responsible for determining investment merit, regardless how limited their investment knowledge and experience may be. This highly structured legal construct absolves our supporting firms from incurring any fiduciary liability from advisors providing investment advice, but in doing so it also minimizes the role and counsel of the advisor to the lowest common denominator of trade execution. Whether the SEC will require advisors to declare fiduciary status or continue defining advisors as only product distributors with some disclaimer requirement, it is clear to all that if advisors are not providing investment advice, then it is not possible for an advisor to add value.

Fiduciary Counsel is in the investor’s best interests, is a preemptive value proposition for the advisor, is required by regulatory mandate, and is the right thing to do





Tremendous cultural resistance to having advisors provide fiduciary counsel comes from NASD brokerage firms, who perceive the accommodation of advisors in this activity as a highly disruptive process requiring significant time and costly resources to develop an infrastructure for providing fiduciary counsel. This should not be surprising, since it would disrupt the conventional ways things have been done within the brokerage industry. Rather than just selling investment products, advisors would be addressing and managing investment and administrative values.

Advisors would be accountable for their recommendations, consumers would expect value to be added, the transparency of cost and performance would be required, and a broad range of investment and administrative values would be addressed and managed, as part of the process, if advisors and their supporting firms are held to an objective criterion for fiduciary counsel. Fiduciary counsel is essentially a new preemptive value proposition that disrupts status quo and would change all the existing rules. Instead of advisor support being geared to the lowest common denominator of trade execution it would be geared to the highest common denominator of fiduciary counsel.

Advisors armed with a preemptive value proposition of fiduciary counsel would have no difficulty competing against advisors who cannot provide investment advice, who do not have the means to determine if they are adding value, even if they were, and who charge a premium for trade execution. In our free market, the inability of today's leading financial services firms to support fiduciary counsel, creates a once in a lifetime opportunity for the leading firms of tomorrow. Imagine building a business around fiduciary counsel, which has a significantly lower structure and three times the multiple of the old commission brokerage model. The financial services industry is being reordered around fiduciary counsel and the consumer and the advisor don't care how difficult it is for the advisor's supporting firm to adapt. This is new school versus old school.

The cultural challenges are great in building institutionalized support for fiduciary counsel. If working within an NASD member firm construct precludes advisors from declaring their fiduciary status, then the independent Registered Investment Advisor (RIA) becomes the structure most conducive to fiduciary counsel. Charles Schwab has built a business division around only serving RIAs who offer their counsel for a fee and

who have abandoned their securities licenses. During this period of change within the industry, while the largest firms are most vulnerable, enterprising smaller firms like TD Waterhouse, Charles Schwab, Fiserv ISS, Wachovia Financial Network, Raymond James IAD, Thornburg, Frank Russell, DFA, and LPL, can win significant market share, if they can build the necessary institutionalized support for offering fiduciary counsel.

Without an existing infrastructure in the financial services industry to support offering fiduciary counsel to individual investors, there exists an experiential and leadership vacuum. The Society of Fiduciary Advisors (SFA), a non-profit trade association of collected wisdom dedicated to establishing standards that define fiduciary counsel and its prudent process, provides a ready resource.

CERTAINLY EVERY ADVISOR WANTS TO DO THE RIGHT THING AND PUT THEIR CLIENT'S INTERESTS FIRST, BUT FEW HAVE ACCESS TO A PRUDENT PROCESS

In order to build institutionalized support for fiduciary counsel, an objective criterion for fiduciary counsel must be established, against which the counsel of the advisor and the support of their firm can be gauged. The SFA's mission is to establish such standards to assure the appropriate level of knowledge and expertise is brought to bear in every circumstance, every time. The SFA will publish in the public domain Generally Accepted Investment Principles and will identify and foster the development of the enabling resources that will bring fiduciary counsel within the reach of all.

The SFA has elicited corporate sponsorship support from of all the firms mentioned above to foster the development of institutionalized support for fiduciary counsel. With this financial support, the SFA, through its Fiduciary Investment Standards Initiative (FISI), will define fiduciary counsel and the prudent investment process for individuals. SFA sponsoring firms are highly motivated to win market share by putting in place the enabling resources necessary to support fiduciary counsel, thus bringing fiduciary counsel within the reach of all. In time there will be thousands of advisors armed with a prudent process, which can be audited back to statute, case

law, regulatory opinion letter, process, procedure, workflow and task. Many of the advisors using the resulting preemptive value proposition will be Fellows in the Society of Fiduciary Advisors.

The SFA has put together an ecumenical group of our industry's top advisors, academicians, technical experts and technologist to define fiduciary counsel and the prudent investment process for individual investors. The FISI for Individuals builds upon the research of the Foundation for Fiduciary Studies, citing statute, Case law and regulatory opinion letters, in defining the breadth of our advice (comprised of 27 practice standards necessary to support fiduciary counsel).

The FISI for Individuals will also build upon the Society of Senior Consultants High Net Worth Standards Initiative that defined Best Practices, or the depth of our advice (comprised of 240 plus values that must be addressed and managed to provide fiduciary counsel). The FISI for Individuals will more fully flesh out best practices, creating a consistent level of granularity in the delineation of Best Practices, as well as more fully delineate trust services, custody, clearing and record keeping.

We are indebted to the following for their selfless contributions in serving on the SFA's FISI for Individuals: Clark Blackman, a CPA and CFA, Co-Founding Principle of Investec Advisory Group and Executive Committee Member of the AICPA-PFP; Steve Kanaly, Vice Chairman of Kanaly Trust and past Chairman of NAPFA; Bob Rowe, Leading Investment Management Consultant and Founder of MyInvestmentPolicy.com and ROWPYN ; Tim Hatton of Hatton Consulting , Author of "The New Fiduciary Standard"; John Lohr an ERISA attorney, Former President of Lockwood, Developer of CIMA-I and CIMA-II courses and the intellectual force behind the legendary EF Hutton Consulting Group, Carol Skinner, QPA of Sterling Retirement Plan Services, an ERSIA Consultant and ASPPA Board Member, Steward Ober an Expert Witness, former CFP Standards Board Member, and member of the Foundation for Fiduciary Studies Board, Frank Sortino, legendary institutional consultant, creator of the Sortino Ratio and Omega Excess, APIC Advisory Board Member, Brent Brodeski of Savant Capital and a founder of the Zero Alpha Group; Spenser Segal, Chairman of ACTIFI, developer of the technology that powers the Center for Fiduciary Studies IFAQ electronic fiduciary review and audit tool; Ron Surz founder of PPCA and developer of PODs and PIPODs and



breakthrough attribution analysis and hedge fund evaluation methodology; Jim Stoker, former APIC Board member and Ethics Chair, pioneering fiduciary advisor in the vanguard of the Independent RIA movement; David Bromelkamp, a CPA and a pioneering fiduciary advisor; Lee Scott. The FISIs for Individual Investors will be managed and edited by Steve Winks.

The FISIs for Individual Investors will define best practices. The higher the level of granularity that is achieved in defining fiduciary counsel, the more scalable fiduciary counsel becomes and the lower it's associated cost. Eighty percent of the 240 plus values thus far identified that have to be managed continuously are disclosure and reporting related which readily lend themselves to automation. Advisors can more effectively leverage through automated processes (electronic wizards) and advanced technology that removes much of the administrative burden from fiduciary counsel, thus bringing fiduciary counsel within the reach of all.

This is important since it doesn't require each advisor to reinvent the wheel every step along the way and results in large-scale institutionalized support for fiduciary counsel. Also by identifying and fostering the development of the enabling resources necessary to support fiduciary counsel, the cost of those resources drop, the better we can scale the advisors services and the more the advisor takes to their bottom line. To that end, the FISIs focus is to establish the process, procedure, workflow and task for each best practice by benchmarking the practices of our leading advisors. This makes it possible for fiduciary counsel to become scalable. This is central to keeping costs low and the democratization of access to resources that will bring fiduciary counsel within the reach of all.

The sequence of events that will result in the SFA fostering institutionalized support for fiduciary counsel is as follows:

1. The FISIs for Individuals will define Fiduciary Counsel establishing best practices.
2. The SFA will engage an AIFA approved firm to audit the practices of ten or so fiduciary advisors against the FISIs Best Practices. From this process, procedure, workflow and task will be established (that will determine what has to be done, what resources are required, who is responsible

for each task, how long does it take, what does it cost).

3. From this, a composite Model for Fiduciary Counsel will be created, which establishes the range of resources required, the implied division of labor within a practice, the profitability of each client, the cost effectiveness of the resources used. (The Model for Fiduciary Counsel will place much emphasis on the process and leveraging the technological and human resources within a practice. These practice management issues in concert with sales and marketing topics by market segment will drive the content of SFA Conferences.)
4. The SFA will in turn engage an AIFA approved firm to audit the prudent process

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of its Corporate Sponsors against its Models for Fiduciary Counsel. If there is a deficiency in a sponsoring firms prudent process, the SFA will help them correct it. If there is no prudent process the SFA will help the sponsoring firm create a prudent process.

5. Once it has been established by an objective AIFA approved third party that an advisor working within for example the TD Waterhouse Prudent Process can fulfill their fiduciary responsibilities, the SFA would grant advisors, who put all their clients assets through TD Waterhouse's Prudent Process, a Fellowship in the Society of Fiduciary Advisors. The SFA Fellow designation goes with the firm's (TD Waterhouse's) prudent process, not the advisor, thus encouraging firms to create institutionalized support for fiduciary counsel. Each SFA sponsoring firm will have their own proprietary approach to managing their prudent process. Some may require advisors working within their prudent process to become AIFAs or establish some degree of competency/

proficiency to assure compliance to a fiduciary standard.

The sponsoring firms are (1) using their scale and buying power to buy down the cost of enabling technology; (2) democratizing low cost access to enabling resources; (3) creating a context in which the advisor can see the value of otherwise abstract technological applications and how they fit together to drive their value proposition; (4) providing wholesale practice management support in helping advisors build their practices. Remember, TD Waterhouse and Schwab do not act as the advisors broker/dealer, since the advisor has relinquished their securities licenses. TD Waterhouse and Schwab are only providing access to enabling resources and empowering advisors on how those resources work together to drive their value proposition.

The advisor is actually managing all those resources and the resulting prudent process. In return for their providing these resources and know how, TD Waterhouse and Schwab earn the record keeping, custody, clearing business of the advisor. The SFA is providing the advisor a context in which to manage all those resources so that the advisor can fulfill their fiduciary responsibilities. The resulting value proposition is preemptive to advisors whose services are limited to trade execution.

If you are a money manager, you will have a profoundly important role to play in advancing fiduciary counsel. Because TD Waterhouse, Schwab et al are not broker/dealers in the traditional sense of their housing the advisors securities licenses, they will not incur the heavy overhead of a product support infrastructure because the fiduciary advisor ascribes no value to product access which has become a commodity. It is a prudent process, or what you do with investment products that add value, not the product in and of itself.

This is what keeps TD Waterhouse's and Schwab's cost down and allows the advisor to maximize their profit margins. But by not replicating the heavy overhead of a product support infrastructure, the role and value of wholesale support is greatly elevated. The wholesale support of money managers becomes the industry's support infrastructure for fiduciary counsel.

The value added of wholesale support is in helping advisors understand how to use enabling resources to build a preemptive value proposition

around fiduciary counsel. This is the pinnacle of wholesale support. If you are Frank Russell, SEI, DFA, AssetMark and have an extremely well conceived means to construct multi-manager portfolios that address and manage a broad range of investment and administrative values, which can be held to a fiduciary standard, you become an invaluable advisor resource. Your wholesale support becomes invaluable because you are (1) literally helping advisors to add value against a custom benchmark at the client level, not just at the money manager's portfolio level and (2) through innovation at the advisor/firm level adopting overlay management, the advisor and their clients avoid double or triple account administration cost while the investment manager maximizes their margins and minimizes their cost and the advisor takes more to the bottom line, streamlining the investment process. Welcome to the new world of fiduciary counsel. The financial services industry is about to be reordered around fiduciary principles and you

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don't want to be left behind. Industry redefining change only occurs once in a lifetime—the window of opportunity is only open for a brief period for those who have the vision, the courage of their conviction and the willingness to execute.

More business is at stake over the next three years than one would have ever dreamed possible. Once the advisor has capitalized on the opportunity, it will be a long time before such an opportunity presents itself again.

All the rules are about to change, what worked in the past will not work in

the future, convention and status quo will work against you. In such an environment, it's a wonderful time to join the SFA as an advisor or to become a corporate sponsor of the SFA—it's the right thing to do, it's in the clients best interests, it's required by state and federal regulatory mandate, and even better, it's in your best interest. Hit this link for a membership application and mail it back or call Steve Winks (804-643-1075) on becoming an SFA Corporate Sponsor.

Notes

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