

SENIOR CONSULTANT

The Voice of the Investment Management Consultant

SEC and DOL: TEN QUESTIONS EVERY ADVISOR MUST ANSWER

by Stephen C. Winks

There is much discussion today concerning fiduciary responsibility, what is it, how do you manage it, where does fiduciary liability begin and end. One of the most provocative questions recently posed to me very eloquently tells us where we are in this industry redefining debate. “What does an advisor do in providing fiduciary counsel, that a broker can’t do?” This is a great question because it clearly establishes the cultural disconnect we must resolve. There is a profound misunderstanding of the broad reaching implications of a brokerage culture evolving to support the broker acting in a fiduciary capacity. As the old saw goes, to a man with a hammer everything is a nail. So too in the brokerage industry, everything is viewed in the context of a trade. We get great insight into the systemic structural change required by reviewing the ten questions the SEC and the DOL have recommended that advisors should answer before their services are engaged.

There is nothing inherently right or wrong with one acting as a broker or as an advisor as long as the consumer knows the difference. The brokerage industry maintains a broker is not accountable for their investment recommendations, may not be acting in the consumers best interest, makes the consumer aware of their investment alternatives and requires the consumer to determine investment merit on their own, regardless of how limited their investment knowledge, experience and acumen may be. Without the necessary resources, it is simply not possible for brokers to add value through a series of disjointed unrelated transactions. On the other hand the advisor is accountable for their investment recommendations, acts in the consumers best interests, provides continuous comprehensive counsel, and rather than sell investment products, the advisor addresses and manages a broad range of investment and administrative val-

ues as required by regulatory mandate and client directive. By design the advisor is empowered to add value through enabling processes and technology. To clarify the differences between a broker and an advisor, the SEC has created a disclosure mechanism, which clarifies who is acting in a capacity of a broker.

On July 22nd, a disclosure statement was required of every broker who is not able to declare their fiduciary status. (The disclosure statement reads: “Your account is a brokerage account and not an advisory account. Our interests may not be the same as yours. Please ask us questions to ensure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interests. We are paid by you and sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons’ compensation, may vary by product and also over time.” This

disclosure statement must be on the front page of every client document, agreement and monthly statement in bold letters so to cause the attention of the consumer.) The disclosure statement makes it clear to the consumer who is acting in their best interest. If there is some question of whether a broker or advisor should be using the disclosure statement, the SEC and the DOL have recommended on June 1st ten questions that a broker or advisor should answer, before a consumer engages their services. Though intended for plan sponsors, these questions have universal application for all investors as they create transparency, so all consumers can better understand in what role and capacity their advisor is acting. Thus the ten questions that follow are helpful in establishing transparency so consumers can determine whether you are acting in their best interests. Your response will help you to determine whether you are acting in a

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capacity of a broker or advisor and whether as a broker you need to use the disclosure statement.

As you respond to the following questions, respond as you can today, and then respond again as you would like to respond. The difference is how far your firm must go to support you in your declaring your fiduciary status.

1. Are you registered with the SEC or a state securities regulator as an investment advisor? If so, have you provided me (the consumer) with all the disclosures required under those laws (including Part II of Form ADV).

Here you should respond yes. If you have more than \$25 million under advisement (soon to be increased) you should be registered with the SEC and Part II of Form ADV should be made available to clients.

2. Do you or a related company (your broker/dealer-supporting firm) have relationships with money managers that you recommend, consider for recommendation, or otherwise mention to the plan (consumer) for their consideration? If so, describe those relationships.

Here you should say no. Hopefully, your supporting firm has no proprietary products. This is beyond your control.

3. Do you or a related company (your broker/dealer-supporting firm) receives any payments from money managers you recommend, consider for recommendation, or otherwise mention to the plan (consumer) for their consideration?

Here the answer should be no. The payment for shelf space, the limiting of shelf space to maximize broker/dealer compensation, the conducting of sales contest, higher advisor compensation for proprietary product—all have been the subject of significant fines, even though they are standard indus-

try practices. Hopefully, if you are a broker, your supporting brokerage firm has dispensed with these practices. This is beyond your control.

4. Do you have any policies or procedures to address conflicts of interest or to prevent these payments or relationships from being considered when you provide advice to your clients?

This is the most difficult question, as it pertains to your independence and objectivity. Your competitors will use this against you to differentiate themselves. Here you should be able to respond:

“THE DISCLOSURES AND TRANSPARENCY REQUIRED ARE VERY HELPFUL FOR ADVISORS AND THEIR SUPPORTING FIRMS TO UNDERSTAND WHAT IS NECESSARY TO FULFILL OUR FIDUCIARY OBLIGATIONS.”

- We do not manage money; we manage money managers.
- We do not accept any revenue from money managers.
- We do not provide brokerage services; we just use brokerage services.
- We have no alliances or external affiliations that would obscure transparency.
- We do not provide services of any kind to investment managers.
- We do not offer actuarial services.
- We do not accept or pay referral fees.
- We do not split fees in any way.
- We do not accept finder's fees for placing managers.
- We do not charge managers for inclusion in our databases.
- We do not accept or pay any soft dollars.

- Our client conferences are not subsidized by investment managers.

5. If you allow plans (the consumer) to pay your consulting fees using the plans (the consumer's) brokerage commissions, do you monitor the amount of commissions paid and alert plans (the consumer) when consulting fees have been paid in full? If not, how can a plan make sure it does not overpay its consulting fees?

Here you should respond all fees are paid as billed in “hard dollars”, \$1 paid for \$1 of services billed. The use of soft dollars or the reimbursement of consulting fees from

commissions at an average rate of \$1.40 in commissions for every \$1 billed, defeats the purpose of best execution. Many firms do not have the technology to monitor soft dollar commission reimbursement arrangements, so they do not know when the advisor has been fully compensate for their services. In recent years soft dollar compensation has been abused. Sometimes trading cost of 15 to 20 cents per share is incurred by the consumer to compensate

advisors, to the detriment of and without the knowledge of the consumer. The use of soft dollars has fallen under considerable regulatory scrutiny both on the basis of disclosure and abusive pricing of trade execution services. In some market segments like defined contribution plans, public funds and Taft-Hartley plans, soft dollar compensation arrangements are pervasive. Many would argue that the mutual fund industry's use of soft dollar compensation to fund incentives is why trading cost of mutual funds are so high, often exceeding 100 basis points in addition to their average fund expenses of 150 basis points.

6. If you allow plans (the consumer) to pay your consulting fees using the plan's brokerage commissions, what steps do you take to ensure that the plan receives best execution for its securities trades?



Your response should be you don't utilize or accept soft dollar compensation arrangements. V-WAP or volume weighted average daily pricing is the institutionally accepted standard for best execution yet very few trading desks at retail firms will acknowledge V-WAP, as it is a very high hurdle (read difficult to profit from) to manage against. Thus best execution remains a mystery at most retail firms because it is managed as a profit center rather than a cost center.

7. Do you have any arrangements with broker/dealers under which you or a related company will benefit if money managers place trades for their clients with such broker/dealers?

Your response should be no.

8. If you are hired, will you acknowledge in writing that you have a fiduciary obligation as an investment advisor to the plan while providing the consulting services we are seeking?

Your response should be yes. Again this may be outside of your control, as it could be in violation of your supporting firms compliance protocol.

9. Do you consider yourself a fiduciary under ERISA with respect to the recommendations you provide to the plan (consumer)?

Your response should be yes. Again this may be beyond your control, as it could be a violation of your firm's internal compliance protocol, but it is not beyond your influence. UPIA, UMPERS, UMIFA all of which advance a fiduciary standard of care as well as ERISA should be consulted and cited for the respective market segments they are applicable.

10. What percentage of your plan clients utilizes money managers, investment funds, brokerage services or other service providers from whom you receive fees?

Your answer should be none. This is very controversial as it alludes to brokerage services as a conflict. By extension its resolution suggests that you do not have to be licensed to sell securities to fulfill your fiduciary obligations. In fact it is an advantage if you are not licensed to sell securities because you avoid the inherent conflicts of interests of your supporting brokerage firm. Charles Schwab has built a very large business work-

for, many of the industry's impediments to supporting fiduciary counsel are resolved. Why not treat trade execution as a cost center rather than a profit center. Trade execution packaged in this fashion, in concert with custody, clearing, reporting and account administration can be structured as broker wrap program with unlimited trading. In doing so it is possible for most conflicts with trade execution to be structurally adverted, but in order for this to work for the consumer and the advisor, large scale institutionalized support for fiduciary counsel must be provided so the advisor can provide the on going counsel necessary to fulfill their fiduciary responsibilities. Because the industry has not provided the large-scale institutionalized support for ongoing fiduciary counsel, the SEC has deemed broker wrap programs as reverse churning, which means ongoing fees are being charged yet no ongoing advice or support is being provided. The SEC views the broker as being paid for services not being provided.

There is no conflict free environment in which to work, there is no means to evaluate all the clients holdings so it is possible to add value, there is no investment policy statement, there is no disciplined approach to portfolio construction, there are no real-time analytics of portfolios that makes continuous, comprehensive counsel possible. The brokerage industry maintains the broker wrap is simply a different pricing mechanism for trade execution services at 1% of client assets. The SEC sees independent advisors providing a well reasoned investment process constituting fiduciary counsel for 1.1% including compensation of the money managers, the advisor, the custodian, trade execution and outsourced supporting resources for fiduciary counsel entailing monitoring, reporting and account administration. Thus the SEC views the brokerage industry as sending a very confusing message with brokerage wrap programs that cannot be held to a fiduciary standard. If the brokerage industry could get a better handle on its cost and

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ing with advisors who have relinquished their securities licenses and solely engage their counsel for a hard dollar client advisory fee. These advisors do not receive fees from money managers, mutual funds or other service providers they utilize. This transparency is central to the advisor fulfilling their fiduciary obligations.

It is clear that there are significant structural changes required within the industry in order for the industry to provide the advisor large-scale institutionalized support for fiduciary counsel. What ever is outside the advisor's control must be resolved in favor of fiduciary counsel. This is not to imply that the brokerage industry is doing anything wrong, it is just to make it clear that there are very specific requirements for the brokerage industry to create large scale institutionalized support for fiduciary counsel.

How does a brokerage firm manage all this change and remain profitable? By simply changing how it is paid and what it is paid



build large-scale institutionalized support for fiduciary counsel—the broker wrap incorporating custody could indeed be the most cost effective and most expedient means to empower brokers to structurally mitigate conflicts of interest and fulfill their fiduciary responsibilities. By the industry making trade execution a cost center, it can circumvent many of the conflicts of interest principally dealing with trade execution and create an environment conducive to fiduciary counsel. The industry would have to streamline its support infrastructure around large-scale institutionalized support (conflict free environment, asset/liability study, investment policy, strategic asset allocation, manager search and selection, performance monitor, tactical asset allocation) for fiduciary counsel in each market segment served thus making fiduciary counsel scalable. This makes it actually more cost effective for the industry to support fiduciary counsel than commission sales greatly elevating the role and counsel of the advisor.

The benefits would be extraordinary, (1) you would simplify the business and greatly elevate the role and counsel of the advisor by building institutionalized support for fiduciary counsel, (2) you create a conflict free environment aligning the firm's best interests with that of the advisor and the consumer, (3) you would eliminate compliance cost that minimizes the role and counsel of the advisor in return for compliance cost that maximizes the role and counsel of the advisor, (4) most importantly you would cut cost, streamline organizational structure, embrace innovation and redeploy resources to modernize institutionalized support for fiduciary counsel and (5) you would elevate the advisor and the industry from a level of counsel possible in 1940 into the twenty-first century. In today's web-based modern business environment one has to ask why trade execution is still the primary pricing

mechanism for the advisors services, especially when trade execution has become a commodity. Brokerage commissions have fallen over 90% from forty cents per share in 1974 to three cents per share today and it is still falling? The New York Stock

“THERE ARE AN INCREDIBLE NUMBER OF WORLD CLASS SUPPORT OPTIONS EMERGING FOR ADVISORS TO PROVIDE WORLD CLASS FIDUCIARY COUNSEL.”

Exchange has bought Archipelago and is going digital, even its seat holder's view the manual practice of floor trading as an anachronism. With large scale institutionalized support for fiduciary counsel, those engaged in commission sales can still execute trades but only better as digital trading is faster, better, cheaper. The value added is

THIS IS AN HISTORIC MOMENT THAT WILL TAKE THE PROFESSIONAL INVESTMENT COUNSEL PROVIDED BY ALL ADVISORS AND UNIFY IT INTO A PROFESSION.”

not trade execution but what the advisor accomplishes with their recommendations, improving overall portfolio return, reducing overall portfolio risk and enhancing the tax efficiency, liquidity, cost structure of the clients holdings as a whole. For this extraordinary value added, the advisor is compensated by a small recurring fee on all the client's holdings that greatly eclipses their earnings derived from isolated disjointed transactions, where it is not possible to add. So, by our leading firms simply changing

how they are paid and what they are paid for, everyone wins by advancing fiduciary principles.

The recent SEC and DOL rulings and advisories are influencing bank owned brokerage firms in how they offer and price their services. A conflict free work environment conducive to fiduciary counsel is one of the driving forces behind several bank owned retail brokerage firms formulating relationship pricing which incorporates non-discretionary investment consulting as well as open architecture comprehensive advisory, trust, credit, checking and savings services all offered for 75 to 100 basis points.

The continuous, comprehensive counsel implied by fiduciary counsel is very profitable, as you advise the client on all their holdings, so there is no cultural inhibition of the brokerage industry in acknowledging the advisors fiduciary status. Because relationship pricing incorporates all products and services the advisor can both add more value and do so less expensively (with advanced processes and technology) than can a product specialist with a singular focus and a limited mandate.

How the financial services industry responds to its fiduciary obligations is the most exciting chapter of the long and storied history of the financial services industry. We are beginning to see our most accomplished advisors who have discretion over substantial assets relinquish their brokerage licenses to avoid conflicts of interest that would inhibit them from acting in a fiduciary capacity. It is economically, technologically and intellectually within the reach of these advisors to embrace breakthrough innovations in advisory services that make fiduciary counsel possible. A new generation of RIAs, built on fulfilling fiduciary responsibility, is emerging. The very highest level of advisor support in due diligence, portfolio construction and advisory services is being

offered by world class firms such as Lydian Trust (their average individual client has \$33 million under their advisement) which serves an outsourced consulting services support enterprise that can be obtained for a flat fee of \$100,000. This is truly world-class support for just ten basis points on \$100 million or one basis point on \$1 billion. Institutional advisors may also choose to engage the supporting services of firms like Callan Associates at \$100,000 per year for help in winning institutional business in the under \$100 million market. Advisors working principally with individuals may choose to engage the support services of Kanaly Trust entailing unlimited fiduciary liability and unlimited client service, customized to each clients needs. Kanaly's services are required at the very high end of the market and are priced per client. All these world-class advisor support services for individuals and institutions are proven and are preemptive to the level of support to which brokers are accustomed. Assuming advisors will only have a few individual or institutional clients with \$5 to \$10 million or more in assets, having access to world-class resources such as these makes a big difference in enhancing your competitive value proposition in providing fiduciary counsel. Firms like Lydian, Callan and Kanaly Trust are to fiduciary counsel what investment products are to commission sales. Everyone wants to deal with an advisor who is capable of providing the highest level of counsel possible, even if they don't need it themselves. There are an incredible number of

world-class support options emerging for the advisor in providing world-class fiduciary counsel.

We are indebted to the SEC and the DOL for addressing and bringing clarity to the broad range of issues that will bring fiduciary counsel within the reach of all. The disclosures and transparency required are very helpful for advisors and their supporting firms, so we can have an understanding of what is necessary to fulfill our fiduciary obligations. We are beginning to see our leading firms, like Smith Barney and Ameriprise (the former American Express Financial Advisors), build large-scale institutionalized support for fiduciary counsel. Their advisors will provide better and unconflicted counsel for the consumer and win significant business because of it. Yet leading the charge for innovation are the RIAs whose interests are in providing world-class counsel, not a mass retail application of fiduciary principles. Though we are still in the early stages of large-scale institutionalized support for fiduciary counsel that will reorder the entire industry around fiduciary principles, the change agents who are pioneering and advancing fiduciary counsel are the RIAs who are blazing a path for the rest of the industry to follow. This is an historic moment, which will take the professional investment counsel provided by all advisors (planners, brokers, consultants, PMers) and unify it into a new profession—the fiduciary advisor.

Notes

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Co-Founder, Publisher & Editor-in-Chief

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Capital Advisory Group

JIM YANNI
Yanni Partners

SENIOR CONSULTANT

1457 Crystal Springs Lane
Richmond, Virginia 23231

Ph 804-643-1075 ■ Fax 804-643-1544

WWW.SRCONSULTANT.COM