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The Moment of Truth: Can an Investor Rely on Their Advisor? On January 31st It All Depends On Whether You Are Acting In a Sales or Fiduciary Capacity

by Stephen C. Winks

Can an investor rely on the investment advice of their advisor? How does an investor determine if their financial advisor is acting in their best interests and fulfilling their fiduciary responsibilities? The consumer trusts their advisor is acting in their best interests, the advisor certainly represents themselves as acting in the clients best interests, so the consumer assumes their advisor is acting in their clients best interests. But, it is a violation of the internal compliance protocol of most NASD member brokerage firms that support the vast majority of the industry's 658,000 licensed advisors who serve the vast majority of investors, for an advisor to acknowledge the fiduciary obligations they have to their clients. So, it is not only not possible for the vast majority of advisors to acknowledge their fiduciary obligations but their supporting NASD member firm will not even acknowledge their advisors provide investment advice. The brokerage industry, the SIA, their trade association, the NASD, their self regulatory organization, all maintain the broker just makes the consumer aware of their investment alternatives, no investment advice is provided, it is up to the consumer to determine investment merit on their own, regardless how limited their investment knowledge and experience may be. Any advice rendered is considered incidental to trade execution. Of course if no advice is being provided it is not possible for the advisor to add value. This legal construct within which all licensed advisors must work, that maintains that investment advisors don't render investment advice, is at the least very confusing and at the most, jeopardizes the trust of the investing public. The role of the advisor is limited to the lowest common denominator of trade execution rather than the highest common denominator of fiduciary counsel.

THE CONSUMER TRUSTS THEIR ADVISOR IS ACTING IN THEIR BEST INTERESTS AND THEIR ADVISOR REPRESENTS THEMSELVES AS DOING SO, SO THE CONSUMER ASSUMES THEY ARE. YET IT IS A VIOLATION OF INTERNAL COMPLIANCE PROTOCOL FOR MOST ADVISORS TO ACKNOWLEDGE THEIR FIDUCIARY RESPONSIBILITIES.

In order to protect the trust and confidence of the investing public, the SEC has created a mechanism that makes it easier for the consumer to determine exactly in what capacity their advisor is acting. Effective January 31st, the SEC is requiring all advisors who cannot declare they are acting in a fiduciary capacity to use a disclosure statement prominently positioned on the first page of all client communications. The disclosure statement reads, "Your account is a brokerage account and not an advisory account. Our interest is not 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 interests and to act in your best interest. We are paid by you and sometimes by people who compensate us based on what you buy. Therefore, our profits, and our sales person's compensation, may vary by product and also over time." For the first time there is a mechanism for the consumer to easily determine whether their advisor is acting in a sales capacity, not obligated to acting in their best interests, or whether their advisor is acting in a fiduciary capacity, acting in the client's best interests. This is profoundly important for a number of reasons, the most important of which is it opens the door for the development of large scale institutionalized support for fiduciary counsel that will bring fiduciary counsel within the reach of all advisors and every consumer.

The SEC is clear on whether an advisor is held to

a fiduciary standard of care:

1. If you are held in a position of trust, and your client relies on your counsel to make an investment decision, you are held to a fiduciary standard of care.

2. If you are providing financial planning or represent yourself as offering financial planning services you are held to a fiduciary standard of care.

3. If you offer advisory services such as asset allocation or manager search and selection for a fee or provide advisory programs for a fee, you are held to a fiduciary standard of care, even if those programs were not intended to be a proxy for fiduciary counsel.

Essentially, if you have a trust relationship with your clients or if you are a financial planner and/or provide financial planning services, or if you are providing fee based advisory services and/or provide advisory services programs, you are held to a fiduciary standard of care.

The effect of the new disclosure statement is on January 31st a new profession—the fiduciary advisor—will be born. The financial advisor will be held in the same professional standing as a physician. There is a professional obligation to act in the client's best interests and to do no harm in providing continuous comprehensive counsel. It is upon this foundation of trust that all professions are built. There are clear differences between an advisor acting in a sales capacity versus a fiduciary capacity, just as there are differences between an accountant and a CPA. The fiduciary advisor addresses and manages a broad range of investment and administrative values required by regulatory mandate and client directive necessary for the client to achieve their goals and objectives. In commission sales the advisor engages in a series of disjointed unrelated transactions where it is not possible for the advisor to add value. The free markets will be the ultimate arbiter of consumer preferences. Will the consumer prefer a disciplined prudent process designed to add value that empowers their advisor to address and manage a broad range of investment and administrative values required by regulatory mandate and client directive? Or, will the consumer prefer a series of disjointed unrelated transactions with no accountability, where it is not possible to add value? The new disclosure statement goes a long way in helping the consumer make informed decisions on their advisors and the counsel they provide.

Thanks to technological advances, today with the right infrastructure in place, it is no more difficult for the advisor to provide fiduciary counsel than to engage in commission sales. In fact it is faster, better, cheaper and more profitable for all concerned to provide fiduciary counsel. Today through decentralized in-house overlay management technology (Smartleaf) it is possible for an advisor to automatically optimize a large number values (risk, return, tax efficiency, liquidity, cost structure, etc.) on an unlimited number of unique custom client portfolios on a daily basis. The economics of fiduciary counsel are compelling for brokerage firms as it entails half the cost structure, three times the multiple while empowering the advisor to deliver an unprecedented level of investment and administrative counsel. Using expert systems the advisor is empowered to go beyond their own personal technical proficiency and interests in adding value for each of an unlimited number of their clients. Historically, there has been no large-scale institutionalized support for fiduciary counsel for fear that the brokerage industry would be responsible for the investment recommendations of tens of thousands of its advisors resulting in great exposure to fiduciary liability. The fear of fiduciary liability has limited the role and counsel of the advisor to the lowest common denominator of trade execution. Yet this fear of fiduciary liability has been mitigated by technological advances, which can bring fiduciary counsel within the reach of all. Thus the challenge the brokerage industry faces is not the enabling resources necessary to support fiduciary responsibility, the challenge is in creating an auditable legal construct (audited back to statute, case law, regulatory opinion letters) that assures the highest common denominator of fiduciary counsel is consistently and routinely brought to bear with every client. Rather than the old legal construct that denies the advisor has fiduciary obligations, a new legal construct that assures the highest level of fiduciary counsel for every client is in order. Now there is a clear way for the consumer to determine whether they can rely on the advice of their advisor, every advisor must now decide whether they wish to act in a sales capacity or in a fiduciary capacity. Every consumer prefers value to be added and wants their advisor to act in their best interests. Will the industry upgrade their advisory services programs and financial planning services so they can be held to a fiduciary standard of care or will the industry distance itself from fee based advisory services and financial planning? Whatever the decision of each individual firm, whether progressive or regressive, it telegraphs to the industry its competitive market stature. Advisors will determine which firms offer the most viable long term support, given changing consumer preferences and technological advances. Come January 31st there will be incredible market pressure for large-scale institutionalized support for fiduciary counsel.

IF YOUR CLIENTS TRUST YOU AND RELY ON YOUR COUNSEL OR IF YOU REPRESENT YOURSELF AS PROVIDING FINANCIAL PLANNING AND/OR FEE BASED ADVISORY SERVICES, YOU ARE HELD TO A FIDUCIARY STANDARD OF CARE.

Harvard's Clayton Christensen, observes in his book "The Innovators Dilemma", "under traditional planning processes, it is impossible for large well established institutions to justify enormous investments to compete in emerging yet to be profitable markets that may never provide decent earnings. Investing in disruptive technology is not a rational financial decision for most established firms." Thus Christensen, by extension, would predict

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the industry will shrink from its regulatory mandated obligation to support fiduciary counsel in order to maintain its proven and profitable business model. The brokerage industry has achieved scale, it doesn't want to do anything new or different that requires a capital expenditure or would not be conducive to maximizing the scale of its existing business model. The industry just wants to better utilize its existing resources, driving down cost and maximizing margins. It doesn't make any difference whether the role and counsel of the advisor is limited to the lowest common denominator of trade execution because the industry's business model is geared to trade execution. But it does make a difference to the advisor and their clients who prefer the highest common denominator of fiduciary counsel. Christensen notes, "by the time the new market (fiduciary counsel) emerges and becomes large and profitable, it will be occupied by entrenched competitors (leaving brokers with the clerical role of trade execution which is becoming a commodity, and divorced from the responsibility of advisory services through which the fiduciary advisor adds value)." Charles Schwab already has announced it plans to offer superior resources in support of fiduciary counsel, a 100% payout and cost breaks that give its advisors a 50% pricing advantage relative to brokerage supported advisors. This puts the brokerage industry in an untenable position of being a high cost, low value added service provider. If no advice can be rendered, no value can be added. Trade execution services can be secured far less expensively from discount brokerages and Electronic Crossing Networks. Christensen may be right that the industry will sacrifice its long term economic viability for short term profit maximization but that would assume the industry's top management is surprised by (1) the consumer preferring value to be added, (2) the existence of technology that empowers advisors each day to automatically address and manage through expert systems the broad range of investment and administrative values required for each of their clients to achieve their goals and objectives (3) a mechanism will be in place effective January 31st for the consumer to discern who is acting in their best interests and who is not. But surely top management is aware of changing consumer preferences, advances in technology and new regulatory imperatives. The brokerage industry may indeed be darned if it acknowledges the fiduciary obligations of its advisors but even worse it is darned as being a high cost, low value added support option if it does not acknowledge the fiduciary status of its advisors. There are no choices for the brokerage industry without consequences. If it continues to deny advice is being provided, it will wither and atrophy. If it acknowledges its advisors fiduciary obligations it must adapt and evolve.

WHETHER THE INDUSTRY UP GRADES THEIR ADVISORY SERVICES TO MEET A FIDUCIARY STANDARD OF CARE OR DISTANCES ITSELF FROM FINANCIAL PLANNING AND ADVISORY SERVICES, IT TELEGRAPHS ITS COMPETITIVE MARKET POSITION.

The brokerage industry is at an historic inflection point. Its firms must adapt or be superceded by firms that will. There is no question the consumer would prefer value to be added and would like to trust that their advisor is fulfilling their fiduciary responsibilities. There is no question the advisor would like to respond. The transformational change in the role and counsel of the advisor, if grasped, can guarantee a firm's growth, if not grasped, can cause firms to wither. As Alfred Sloan prophetically observed, "too much success can be fatal as it dulls the competitive senses…companies may fail to recognize changing consumer preferences or advances in technology." Harvard's Clayton Christensen observes, " the biggest mistake our largest most established firms make is to look at innovation in the context of their existing business model when a new business model is in order."

Have the industry's major Wall Street firms become so successful that they can not recognize changing consumer preferences and advances in technology that render them vulnerable to faster, better, cheaper and more profitable business models? Will Charles Schwab or Fidelity grasp transformational change and provide the next generation of industry leadership? Will it be a new generation of potentially massive RIAs who will redefine the industry around fiduciary principles? Will it be the banks whose competitive senses are alerted to the opportunity of winning back their once dominant HNW market share by leveraging their fiduciary capacity and using best in class outside managers? Or will the business model required be beyond any established institution so that by default large RIAs dominate the industry? Only the truly leading firms in the industry will have the answer.

To accelerate the industry's evolution, the Society of Fiduciary Advisors' Fiduciary Investment Standards Initiative (FISI) has defined Best Practices in Providing Fiduciary Counsel for Individual Investors. By defining advice the FISI for Individuals makes fiduciary counsel scalable, so it is possible to build large-scale institutionalized support for fiduciary counsel. By the SFA's FISI for Individuals working backwards from statute, case law and regulatory opinion letters, our industry's best and brightest advisors and technical experts have established best practices or the "how to" of fiduciary counsel. The implications of the FISI for individuals are profound. Steve Drozdeck, the former global head of professional development for Merrill Lynch tells us, "there is a three question test ('how to', 'want to', 'chance to') that establishes whether an objective can be achieved by training ('how to') or through adapting culture ('want to') or through resources ('chance to')." The Society of Fiduciary Advisors FISI for individuals answers the critical question of "how to". Next month in SENIOR CONSULTANT the SFA will establish the enabling re-

sources necessary to support fiduciary counsel, which answers the "chance to" resource question. The cultural question or the "want to" can only be answered by either the top management of each firm who charts the firm's course or by that firms advisors. Certainly each firm will establish their own culture, but the advisor chooses which firm will best support their work in adding value and acting in their clients' best interests. Thus the moment of truth on January 31st. Our industry' best and brightest, who are compelled to act in their client's best interest, have no choice but to seek out firms that best support fiduciary counsel. Once firms get past acknowledging their advisors fiduciary obligations, it then becomes an arms race on which firm best supports fiduciary counsel. Schwab institutional is built around RIAs who have relinquished their brokerage licenses, to avoid the conflicts of interest and constraints of NASD member firms. The 3,000 RIAs at Schwab who have $100 million or more under advisement have consistently beaten the 14,000 advisors at Merrill in net new assets garnered. This is significant because Merrill has more million-dollar producers than all the other major wirehouses combined and the advantage for Schwab in winning assets will only accelerate with the SEC's new disclosure statement. The marketplace is telling us there is a clear advantage in acting your client's best interest and in wining assets by relinquishing your brokerage license and working outside a NASD construct. This is only resolved by NASD member firms acknowledging the fiduciary status of their advisors. Come January 31st our industry's leading firms will be supporting fiduciary counsel. They may not be the industry's largest firms but they are clearly the best, based on objective criteria of acting in the consumer's best interest.

The FISI for Individuals has been put in the public domain for any and all who wish to support fiduciary counsel. It is around our continually evolving understanding of best practices, based on statute, case law, regulatory opinion letters, that large-scale institutionalized support for fiduciary counsel and the profession of fiduciary advisors will be built. By the SEC requiring advisors to declare their fiduciary status, the easy part is to make the declaration; the difficult part is having an auditable prudent investment process and actually fulfilling our fiduciary responsibilities. For most advisors this requires large-scale institutionalized support for fiduciary counsel. A prudent investment process must be documented so one's fiduciary counsel can be audited back to statute, case law and regulatory opinion letters. The FISI for Individuals is the first step in making this possible. Fiduciary counsel is no longer good intentions with out any objective criteria. We are at the genesis of a new profession, a code of ethics is required, policies and procedures are required, and a prudent process is required. To discover the prudent investment process and what is required of us to fulfill our fiduciary obligations just hit this link . How well you compete in the post January 31st competitive business environment is determined by how well your firm empowers you to fulfill your fiduciary responsibilities. Because prior to January 31st firms have been reticent to support fiduciary counsel, you may need to guide your firm on what you may need.

In our next issue we will outline the enabling resources necessary to support fiduciary counsel. ■

Notes