



THE NEW FIDUCIARY STANDARD: STILL PENDING IN CONGRESS, BUT YOU CAN MOVE FORWARD NOW

One of the countless outcomes of the Great Recession is the drive to create legislation to prevent another financial disaster event in the future. Among many issues addressed in House and Senate versions, proposed regulations would end the banks “too big to fail” status and create a Consumer Financial Protection Agency.

And ... there is a special section in each pending bill that is just for you, the financial advisor.

According to the Senate’s proposal (Restoring American Financial Stability), the legislation will protect investors and businesses as it “provides tough new rules for transparency and accountability from investment advisors, financial brokers and credit rating agencies.”¹

The potential legislation has revived a debate dating back at least to 1934 when the newly-created Securities and Exchange Commission (SEC) was given authority over broker-dealers. In 1940, the Investment Advisers Act created a structure for individuals and firms engaged in giving investment advice. What is being addressed here is the gap between the responsibilities that broker-dealers and registered investment advisers (RIAs) owe their clients.

Today, transaction- and commission-driven brokers stand on one side of a line. Fee-compensated investment advisers with a long-term focus and fiduciary responsibilities stand on the other side. In practice, however, it is not an either/or career choice for someone who wants to provide financial services for individuals.

There is a virtually infinite array of choices for occupations that provide investment choices to consumers. For example, job-seekers can choose dual-registration as broker and advisor, and they can select from an array of firms that range from individual practices to wirehouse operations with thousands of brokers. So, in the real world, there is a “free market” with a multitude of ways to provide investment services to retail customers and an overlapping of regulation and responsibility.

What does this mean for consumers – in other words, your current and prospective retail clients?

On the plus side, individuals have hundreds of thousands of choices as they seek financial advice that fits their needs and asset levels. They can seek and find a financial counselor whose business is consistent with their level of assets and personal qualities.

Customers do not understand the difference

On the downside, however, consumers do not understand the basic difference between an RIA and a broker. The 2008 RAND study, commissioned by the SEC, is definite about this. In looking for investment advice that they can trust, retail clients do not know that an RIA is held to a higher standard – that is, to act in the customer’s best interest – than is the broker, who is expected to provide products that are “suitable” for the customer. Consumers are not likely to understand the motivation that might be part of the investment recommendation.

With differences in tradition and history, compensation practices and divergence in current laws and regulators, the voices clamoring for attention in this new legislation are many and varied. At one end of the spectrum, financial planning advocates want a fiduciary standard that applies uniformly to everyone who gives any kind of financial advice. Other groups want the bar lower, maintaining a suitability requirement for “incidental” advice.

Change is coming, with or without legislation

Since it has not passed into law yet, and the outcome remains uncertain, why should this proposed legislation make much difference to your practice?

The answer is that some change is coming. At the very least, the trend is clearly toward more stringent oversight and enforcement of existing regulation. With new leadership at the SEC, stung by criticism of its failure to catch Bernie Madoff, the agency is moving ahead with changes of its own, and the result will likely be to bring broker-dealer and adviser oversight closer together.

One step the SEC is taking is to integrate broker-dealer and investment adviser examinations. “The SEC has instituted several measures to integrate the broker-dealer and investment adviser examination programs. The New York Regional Office ... will integrate examination teams to make sure people with the right skill sets are assigned to examinations. Under the new protocol, a single team of examiners, drawn from the broker-dealer and investment management units, will jointly examine selected firms to ensure that the examination team includes those most expert in the subject of the exam.”²

Move Forward Now

Interestingly, while lobbyists and trade groups line up to influence legislation, at least one survey shows that consumers also want more regulation. A pro-fiduciary group, the Financial

Highlights: Selected Differences between Brokers and Registered Investment Advisers

	Broker-dealer	Registered Investment Adviser
Regulatory oversight	Broker-dealers must register with the SEC. Most oversight has been assigned to the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization.	Advisers register with the SEC. Smaller RIAs register with their states.
Responsibility to client	Suitability under the “know your client” umbrella.	In the client’s best interest, a higher standard than suitability.
Usual compensation practice	Sales commissions related to specific financial products.	Most commonly, fees as a percent of assets under management. Some advisers charge an hourly rate.
Industry advocates	<ul style="list-style-type: none"> • Securities Industry and Financial Markets Association • Insurance groups • Securities Investor Protection Corporation 	<ul style="list-style-type: none"> • Financial Planners Association • Committee for the Fiduciary Standard • Financial Planning Coalition • National Association of Personal Financial

Planning Coalition, commissioned a survey that found 83% of registered voters support increased regulation for financial planners.³

The transition to stronger fiduciary responsibilities has a strong tail wind, and advisors should be looking ahead and preparing. Consider these essential steps:

- Make sure your clients understand the advantage of a fiduciary standard.
- Establish “best practice” processes within your office, and use technology to support that initiative.

Make sure your clients understand your principles

As a registered adviser, you have already decided that a fee-based practice is better for your clients and better for you. Fees as a percentage of total client assets under management support lifetime client objectives and goals, rather than short-term results of transactions and trades.

More important, fees align your client’s objective (an increase in wealth over time), with your own interest. That is because your fees increase as wealth increases – not because the percentage increases, but because the dollar amount of assets increases.

Be clear when you talk to clients. (Remember the RAND study: people do not understand the differences between broker and RIA standards of care.)

Start early, on your first presentation with a prospect. Then incorporate this information into the initial meeting as a way to justify your fees. It should become a foundation of your relationship with the client.

Following are ideas as to how you can explain your fiduciary duty to clients. This first example contrasts a fee-based model with a commission base.

There are two ways I can earn money in the field of personal financial services:

I can make a sale and get paid a commission up front – let’s say 5%. Then I get a small trailer payment as an incentive to keep you in that investment.

Or I get paid fees, which are typically about only 1% of the value of the account. If your account

assets go up, I get paid more. If it goes down, then my income takes a hit right along with your results.

You could follow up with the conclusion that the interests of a client and a fee-based advisor are closely aligned.

What that means is that our interests are aligned. We are sitting on the same side of the table. My incentive is to maintain a long-term relationship with you, Mr. and/or Ms Client.

I choose this way of getting paid because I believe it supports an objective perspective for helping you grow your assets and meet your personal goals.

If you have a designation such as CFP, be sure that these letters are not just “alphabet soup” to your clients. Provide printed documentation for the standards that you have agreed to as part of your certification and that you have met specified requirements in education and competency.

Best Practices, Best Technology

The details are yet to be decided, but the trend is clear. Consumers, RIAs, many broker-dealers and the current administration are largely on the side of stricter standards. Even as you already adhere to the higher fiduciary standard, you will need to document the rationale behind risk tolerance assessment, portfolio recommendations and transparency.

More and better record-keeping will become an even more essential component in the future. Prepare now for more stringent audits, where you will be asked for recorded proof that you aligned your clients’ risk profiles with appropriate investments. It is time to move toward “best practices” for your compliance processes

“Our analysis confirmed findings from previous studies and from our interviews with stakeholders: Investors had difficulty distinguishing among industry professionals and perceiving the web of relationships among service providers.”⁴

and an office technology structure which supports the portfolio consulting and reporting procedures that will be required in the near future.

Regardless of the outcome of the pending legislation, documentation will continue to become more essential to an efficient, successful advisory practice in the future. Leverage technology to strengthen the growth of your business.

Looking ahead at the fiduciary standard

Fallout from the economic disasters of the past few years is putting the spotlight on a higher fiduciary standard for advisors. Pressures to meet additional regulation, provide more records and meet technical requirements are relentless.

It is easy to think that these demands are simply distractions that waste time and detract from the core of your business: direct communications with your clients.

The good news is that your regulatory obligations and ability to serve your clients are not in conflict.

Your fiduciary obligation is an essential part of the value you provide to your clients. It supports an objective, long-term commitment to your client and practice. It validates your fees and the way you manage your business. Make sure your clients understand what a fiduciary standard means for them.

Information Source

“Over the Years, the Rules have Changed,” a summary of adviser / broker-dealer regulation can be found at :
www.nytimes.com/2010/02/16/business/16adviserside.html?scp=3&sq=fiduciary%20standard&st=cse

1 http://banking.senate.gov/public/_files/FinancialReformSummaryFC11189.pdf

2 <http://sec.gov/spotlight/secpostmadoffreforms.htm#integrate>

3 www.financialplanningcoalition.com

4 Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (“RAND report”) by Angela A. Hung, et al. Sponsored by the United States Securities and Exchange Commission, 2008. Executive Summary, page xix.

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