

The New Fiduciary Standard: How Will It Impact Trustees & Advisors?

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June 14, 2016

Geneva

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A Brief Disclaimer:

The presenter is not an attorney and is not providing legal advice. The information presented herein is the author's opinion and commentary on the issues, and should not be construed as, or relied on, as legal advice.

AGENDA

- Introduction
- A Brief (Modern) History of Fiduciary
- Where We Stand Today
- Implications for Trustees, Advisors & Investors
- Q&A

A Brief (Modern) History

- **Crash of 1929 & The Great Depression**
- Series of Congressional **Investigations & Legislation** Intended to Eliminate Certain “Abuses in the Securities Industry, Abuses Which were Found to have Contributed to the Stock Market Crash of 1929 and the Depression of the 1930s”*

* Source: SEC v. Capital Gains Research Bureau, 375 U.S. S. Ct. 180 (1963)

A Brief (Modern) History

- **Investment Advisors Act of 1940** and subsequent court rulings* establish:
 - The “highest ethical standards” must “prevail in every facet of the securities industry”
 - “Investment Advisors could not completely perform their basic function – furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments – unless all conflicts of interest between the investment counsel and the client were removed” (*emphasis added*)
 - Investment Advisors “should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice..”

* Source: SEC v. Capital Gains Research Bureau, 375 U.S. S. Ct. 180 (1963)

Investment Advisors as Fiduciaries

- 6 Essential Aspects of Fiduciary Responsibility:
 - Serve the client's best interest
 - Act in utmost good faith
 - Act prudently -- with the care, skill and judgment of a professional
 - Avoid conflicts of interest
 - Disclose all material facts
 - Control investment expenses

Source: "Six Core Fiduciary Duties of Financial Advisors"

<http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/09/InstituteSixCoreFiduciaryDuties.pdf>

So, What's the Problem?

- Two Little Words:
 1. Exemptions
 2. Suitability
- Compounded by Secular Changes in the Marketplace

Exemptions

Under the 1940 Act Certain Players in the Securities Industry were Exempted from Registering with the SEC as Investment Advisors:

- Professionals whose investment advice to clients is incidental to the professional relationship;
- Banks, publishers and government security advisors; and
- *Any broker or dealer whose performance of advisory services is solely incidental to the conduct of their business as a broker or dealer and who receives no special compensation thereof.*

Suitability

Instead of registering as investment advisors with the SEC and therefore being bound to adhere to a fiduciary standard that requires them to put their clients' interests ahead of their own, broker dealers are regulated by FINRA and required to adhere to a suitability standard, without any general fiduciary obligation solely to the client

- FINRA is a self-regulatory body overseen by the SEC
- Unlike fiduciary duty, which requires an investment adviser to put their own interests after those of their clients, suitability only requires that the broker-dealer reasonably believes that any recommendations made merely suit the client's financial needs, objectives and unique circumstances.
- In addition, a broker's primary duty is to the broker-dealer he or she works for, not the client.

Changes in the Marketplace

- Creation of Financial Supermarkets – Focus on Sales & Distribution
- Transition of Wall Street Firms from Partnerships to Publicly Traded Companies – Misalignment (Agent vs Principal)
- Broker Dealers & Investment Advisors Under the Same Roof – Dual Registrants
- The Proliferation of the Term “Advisor” – Used by Brokers and Registered Advisors Without Distinction

The Result: Investor Confusion

2006 Investor Perception Study Commissioned by TD Ameritrade

1. % of Investors who Believed that both Stockbrokers and Registered Investment Advisors (RIAs) have a Responsibility to Act in their Best Interests → **54%**
2. % of Investors who Did not Understand the Different Obligations Required of RIAs & Stockbrokers (Unlike Stockbrokers, RIAs have an Obligation to Act in an Investor's Best Interest in all Aspects of the Financial Relationship) → **74%**
3. % of Investors who Said they Would Rather Work with an Investment Adviser if they Knew Advisors Provided Greater Investor Protection than Stockbrokers → **79%**

And then Another Financial Crisis... and Another Series of Congressional Hearings



More Congressional Hearings



Senator Susan Collins (R-ME): “Could you give me a yes or no to whether you consider yourself to have a duty to act in the best interests of your clients?”

Daniel Sparks of Goldman Sachs: “I believe that we have a duty to serve our clients well.”

S. Hrg. 111-674. “WALL STREET AND THE FINANCIAL CRISIS: THE ROLE OF INVESTMENT BANKS” Hearing before the PERMANENT SUBCOMMITTEE ON INVESTIGATIONS of the COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, UNITED STATES SENATE, ONE HUNDRED ELEVENTH CONGRESS, SECOND SESSION, VOLUME 4 OF 5 - APRIL 27, 2010

So Congress Acts... Again

Dodd-Frank Wall Street Reform and
Consumer Protection Act
July 21, 2010

“The Commission [Congress Directing the SEC] May Promulgate Rules to Provide that, with Respect to a Broker or Dealer... The Standard of Conduct... Shall Be The Same as the Standard of Conduct Applicable to an Investment Adviser Under... The Investment Advisors Act of 1940”

And the SEC Takes them Up on it (Well... Sort of... They Conduct a Study

January 2011 SEC Study on Investment Advisors and Broker Dealers as Required by Section 913 of The Dodd-Frank...Act

“Many Investors are... Confused by the Different Standards of Care that Apply to Investment Advisors and Broker Dealers. That Investor Confusion has been a Source of Concern for Regulators and Congress”

“The Staff Recommends the Consideration of Rulemaking that Would Apply Expressly and Uniformly to both Broker-Dealers and Investment Advisors, When Providing Personalized Investment Advice About Securities to Retail Customers, a Fiduciary Standard, **No Less Stringent** (*emphasis added*) than Currently Applied to Investment Advisors Under Advisors Act”

And then Nothing Happens

- From July of 2011 to the Current Date – The SEC has Yet to Issue Rules Regarding a Common, Harmonized Fiduciary Standard
- Fierce opposition and lobbying from insurance, mutual fund firms and broker dealers
- The main argument opponents make is that a fiduciary standard would harm the small investor because it would cause advisors to exit the market if they have to be fiduciaries
- Issue becomes highly politicized and put in the context of “unnecessary regulation”

In Fact – Things Have Gone Backwards

- The “disclose conflicts” exception has swallowed the “avoid conflicts” principal, effectively re-defining one of the core aspects of fiduciary duty – as defined by the ‘40 act and reaffirmed by the Supreme Court in 1963
 - Fiduciary \neq Avoiding Conflicts of Interest
 - Fiduciary = Disclosing Conflicts of Interest

The Old Normal: Conflicts are to be Avoided

1960s (US Supreme Court)

“Investment advisors could not completely perform their basic function...unless all conflicts of interest between the investment counsel and the client were removed”*

2006 (SEC Senior Staff Member)

“An adviser must act solely for the benefit of its client and must not place itself in a position of conflict with its client. An exception is made when the adviser makes full disclosure to its client and obtains the clients informed consent”**

The Old Normal: Conflicts are to be Avoided

2012

“Conflicts of interest can be thought of as the viruses that threaten...well-being. These viruses come in a vast array of constantly mutating formats, and if not eliminated or neutralized....[are a]...mortal threat to the body”***

* Source: US Supreme Court 375 U.S. 180 (1963)

** Robert E. Plaze, *The Regulation of Investment Advisors*, November 2006

***Carlo diFlorio, Director SEC office of Compliance, Inspections and Examinations, 2012

The New Normal: Conflicts are Normal & Acceptable, They Just have to be Disclosed

According to the SEC:

2014*

“Total Wealth breached their fiduciary duty..by failing to adequately disclose the material information about the revenue sharing fee arrangements and the conflicts posed by these arrangements”

2014**

“This matter involves an investment adviser’s failure to disclose compensation it received through agreements with a registered broker-dealer and conflicts arising from that compensation”

The New Normal: Conflicts are Normal & Acceptable, They Just have to be Disclosed

2015***

“An investment adviser failed to disclose compensation received through an arrangement with a broker-dealer. The violation, was a failure of disclosure”

** In the Matter of Total Wealth Management, Inc.*

*** In the Matter of the Robare Group, LTD*

**** In the Matter of Shelton Financial Group, Inc*

In the Meantime – The White House Takes Matters into it's Own Hands

- 2010 Assistant Secretary of Labor Phyllis Borzi Proposes Making all Brokers Subject to the '40 Act Fiduciary Standard
- 2011 Rule Pulled in Face of Significant Pushback from Brokerage, Insurance and Mutual Fund Industry (General Assumption was that SEC Should Make These Rules, not Dep't of Labor)

In the Meantime – The White House Takes Matters into it's Own Hands

- 2015 White House Council of Economic Advisors Chairman Jason Furman Issues Memo to President Saying Harmful Conflicts of Interest Cost Investors \$17B a Year
- 2016 President Obama Authorizes Department of Labor Secretary Perez to Issue New Rules Requiring Brokers who Advise Investors on Retirement Accounts be Subject to Stricter Fiduciary-Like Obligations
- Department of Labor Issues New Rules

Department of Labor Rules: April 2016

“Going forward, those that provide investment advice to... plan participants, beneficiaries and IRAs and IRA owners must either avoid payments that create conflicts of interest or comply with the protective terms of an exemption issued by the Department.

Under new exemptions adopted with the rule, firms will be obligated to acknowledge their status and the status of their individual advisors as "fiduciaries." Firms and advisors will be required to:

- Make prudent investment recommendations without regard to their own interests, or the interests of those other than the customer;
- Charge only reasonable compensation; and
- Make no misrepresentations to their customers regarding recommended investments.

Department of Labor Rules: April 2016

Together, the rule and exemptions impose basic standards of professional conduct that are intended to address an annual loss of billions of dollars to ordinary retirement investors as a result of conflicted advice.”*

* Source: US Department of Labor: **Fact Sheet: Department of Labor Finalizes Rule to Address Conflicts of Interest in Retirement Advice, Saving Middle-Class Families Billions of Dollars Every Year**

But There's that Nasty Word Again: Exemption

The Best Interest Contract Exemption (BICE) permits firms to continue to rely on many current compensation and fee practices, as long as they meet specific conditions intended to ensure that financial institutions mitigate conflicts of interest and that they, and their individual advisors, provide investment advice that is in the best interests of their customers. The exemption requires:

- The financial institution to acknowledge fiduciary status for itself and its advisors.
- The financial institution and advisors must adhere to basic standards of impartial conduct, including giving prudent advice that is in the customer's best interest, avoiding making misleading statements, and receiving no more than reasonable compensation.
- The financial institution also must have policies and procedures designed to mitigate harmful impacts of conflicts of interest and must disclose basic information about their conflicts of interest and the cost of their advice.

* Source: US Department of Labor: **Fact Sheet: Department of Labor Finalizes Rule to Address Conflicts of Interest in Retirement Advice, Saving Middle-Class Families Billions of Dollars Every Year**

So Where Does that Bring Us to Today?

- Much attention being paid to “fiduciary.” Yet, confusion that has existed for quite some time is likely to persist:
 - Now effective 3 standards instead of 1: “Why Do I Get Different Advice in my Retirement Account than I Do in my Regular Investment Accounts?”
 - Lots of interpretation required: “best interest” and “reasonable” – could take 20+ years to wind way through court system (remember the ‘40 act and 23 years to get a court case to reaffirm it)
 - In meantime, industry likely to take solace in SEC and courts’ redefinition of fiduciary to be first and foremost about disclosing conflicts of interest, and not avoiding them
- And keep in mind, while everyone wants “rules” – fiduciary at its core is about principles
- Regulation alone won’t do the trick – advisors & investors need to demand more

The Bottom Line: Caveat Investor (or Trustee)

- The Burden of Finding a Fiduciary Advisor Remains on the Investor (or Trustee) & it's Hard to Cut through the Clutter
 - Everyone still has the title “Advisor”
 - Many firms make fiduciary-like promises:

“It’s Time for a Financial Strategy that Puts Your Needs & Priorities Front & Center”
 - Dual registration persists
 - Many business models intentionally blur the difference between advice and sales

A Case Example: The \$1B+ Investor who Wanted a “Simple Portfolio” & Couldn’t Get One

- Most risk being taken in operating company
- Defined relatively simple allocation that he wanted his providers to achieve
- Needed to work with PWM units of global financial institutions due to needs of his operating company
- Most “advisors” said we can do better than your benchmark; none recommended simple, low-cost portfolio implementation (because of their own business models)
 - Calendar year 2015 “cost” to investor: \$13 Million
 - \$2 million in fees
 - \$11 million in below benchmark performance

Guidance for Advisors who Want to be True Fiduciaries

The Institute for the Fiduciary Standard: Advisor Best Practices

General Practices

1. Affirm that the Fiduciary Standard Under the Advisors Act of 1940 Govern Client Relationship at all Times
2. Establish & Document a “Reasonable Basis” for Advice in the Best Interest of the Client
3. Communicate Clearly & Truthfully, Both Orally and in Writing. Do not Mislead. Make all Disclosures & Important Agreements in Writing
4. Provide a Written Statement of Total Fees & Underlying Investment Expenses Paid by the Client. Include any Payments to the Advisor of the Firm or Related Parties for Any Third Party Resulting from the Advisor’s Recommendations

Duty: Act in Utmost Good Faith

Guidance for Advisors who Want to be True Fiduciaries

The Institute for the Fiduciary Standard: Advisor Best Practices

- Duty: Loyalty**
5. Avoid Conflicts & Potential Conflicts. Disclose all Unavoidable Potential & Actual Conflicts. Manage or Mitigate Material Conflicts. Acknowledge that Material Conflicts of Interest are Incompatible with Objective Advice
 6. Abstain from Principal Trading Unless a Client Initiates an Order to Purchase the Order on an Unsolicited Basis
 7. Avoid Compensation in Association with Client Transactions
 8. Avoid Gifts or Entertainment that are not Minimal and not Occasional. Avoid Third Party Payments, “Benefits” and Indirect Payments that do not Generally Benefit the Firm’s Clients & May Reasonably be Perceived to Impair Objectivity

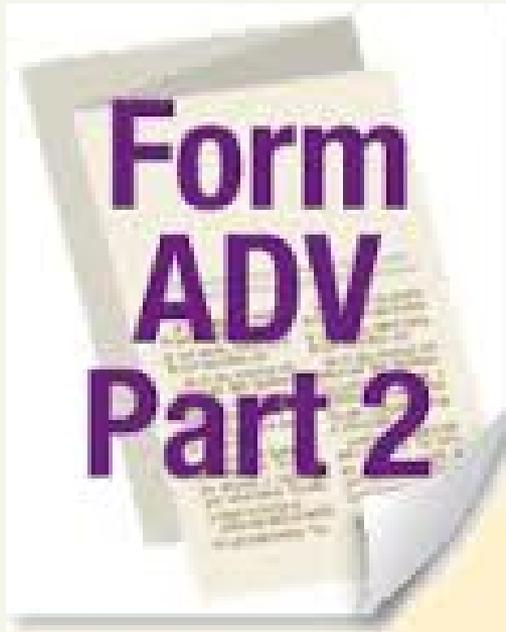
Guidance for Advisors who Want to be True Fiduciaries

The Institute for the Fiduciary Standard: Advisor Best Practices

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| Duty: Act Prudently | 9. Ensure Baseline Knowledge, Competence & Ongoing Education Appropriate for Engagement |
| Duty: Control Investment Expenses | 10. Institute an Investment Policy Statement or Process that is Appropriate to the Engagement & Describes the Investment Strategy |
| | 11. Consider Peer Group Rankings in Ensuring Underlying Investment Expenses are Reasonable |
| Duty: Affirm Compliance | 12. Affirm in Writing Adherence to Best Practices, and Attain Written Affirmation from the Firm that these Practices May be Met by the Advisor |

* Source: The Institute for the Fiduciary Standard

Guidance for Trustees & Investors who are Seeking Out Fiduciary Advisors



Please retain a copy of this brochure for your records.

Amerivest Investment Management, LLC
December 2009

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Guidance for Trustees & Investors who are Seeking Out Fiduciary Advisors

The Institute for the Fiduciary Standard: Investor Bill of Rights

I expect that my fiduciary advisor:

1. Meets the highest standards and puts my interest ahead of his/her own at all times.
2. Understands my circumstances, needs, goals and risk tolerance.
3. Puts our agreement in plain writing that includes an investment policy statement or process that reflects my goals and philosophy.
4. Provides communication that is timely, truthful, complete and understandable so I am well informed. Puts important agreements in writing.
5. Gives me advice that is objective and unbiased and based on my needs.

Guidance for Trustees & Investors who are Seeking Out Fiduciary Advisors

The Institute for the Fiduciary Standard: Investor Bill of Rights

6. Is educated and credentialed in personal finance and investing, dedicated to professional education and experienced in advising investors like me.
7. Reports regularly on my investments' performance, the fees and expenses I pay and the fees the firm receives as a result of advising on my portfolio. On request, provides written records that explain any recommendations.
8. Avoids conflicts of interest. If a conflict is unavoidable, the advisor discloses the conflict, discusses it with me and manages it for my benefit.
9. Avoids receiving payments from other parties (like mutual funds). If unavoidable, the payment is either credited to me or managed for my benefit.
10. Controls investment expenses so the fees and expenses I pay are reasonable.

Some Online Resources



Thank You

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