INSTITUTE FOR THE FIDUCIARY STANDARD

Fiduciary Reference

Analysis of Investment Fiduciary Issues

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What Investors Can Learn About An Advisor's Conflicts in Form ADV: 'But Were Not Sure How to Ask'

RIAs DNA of objective investment advice is embedded in the Advisers Act of 1940. What's often over-looked, however, are differences among RIAs on measures in the Adviser's Form ADV that serve as 'fiduciary indicators'. The research identifies some of these indicators and explores some of these differences.

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Introduction

This year 11,847 SEC – registered investment advisers (RIAs) employ 386,532 employees who provide investment advisory services to more than 36 million clients, according to this year's study by the Investment Adviser Association and National Regulatory Services.[1] Each RIA is required by law to annually file a Form ADV with the Securities and Exchange Commission. The Securities & Exchange Commission explains, "Form ADV is the uniform form used by investment advisers to register with both the Securities and Exchange Commission (SEC) and state securities authorities." Form ADV Part I and Part II offer investors a wealth of data about the size, scope and nature of the RIA business.

These data reveal the differences and similarities among RIA firms in how they conduct their businesses. Chief among the questions is the degree to which firms minimize conflicts of interest and render financial and investment advice for a fee solely paid by clients.

The Institute looked more closely at this question by surveying the ADVs of 135 RIAs with assets between 250 mm and 164,000 mm AUM and nine of the larger financial services firms. [2]. The Institute sought to obtain a snapshot of where RIAs typically stood regarding business lines, employees' registrations, revenues and compensation and conflicts. Specifically, the research aimed to identify areas of commonality and differences among the RIAs and then, separately, between RIAs and the large financial services firms' advisors.

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Background

What the Advisers Act intended. The foundation of federal securities laws for investment advice and the importance of fiduciary duty derives from the Investment Advisers Act of 1940. "Fundamental to the (Investment Advisers) Act is the notion that an adviser is a fiduciary," notes Robert E. Plaze. Former Deputy Director of the Division of Investment Management of the U.S. Securities and Exchange Commission. In a detailed discussion, Plaze outlines adviser responsibilities and highlights the principles underpinning what fiduciary means.

Plaze underscores that the fiduciary responsibilities of an adviser *are* rigorous and reflect the stringent ethical demands of high professional standards. He describes the specific care fiduciaries are held to: a "Sensitivity to the conscious and unconscious possibility of providing less than disinterested advice…. And (the adviser) may be faulted even when it does not intend to injure a client and even if the client does not suffer a monetary loss." [3]

The rigorous view Plaze expresses reflects the views seen in an SEC report that became a strong basis for the Advisers Act. This same report was highlighted by the Supreme Court in 1963 in the landmark case, SEC v Capital Gains Research Bureau. [4] As the Court notes about the SEC report:

"The report reflects the attitude – shared by investment advisers and the Commission – that investment advisers 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 were removed."

Why the Advisers Act fiduciary standard is rigorous. As significant as *what* fiduciary principles mean is *why* they were instilled in the Advisers Act. Rutgers University law professor, Arthur Laby, answers this question in his research on the history of the Advisers Act. Laby points out that while the Securities Act of 1933 and Exchange Act of 1934 responded to the crisis of the stock market collapse and the depression, by 1940 the environment had changed, so that "The Advisers Act instead grew out of study and reflection." Laby cites an SEC report and one of the main concerns "bedeviling advisory firms," as a rationale for the Advisers Act.

"The first was that so-called "tipster" organizations were disguising themselves as legitimate advisory organizations. [60] Certain firms providing advice were affiliated with investment banks or brokerage. firms and, therefore, had a vested interest in recommending particular securities…. [5]

The background of the Investment Advisers Act of 1940 reveals how much preserving "disinterested advice" was the focus of regulators and industry leaders in 1940. This background provides an important context for evaluating how well advisers adhere to Advisers Act fiduciary principles today.

Key Findings

The RIA Firms

- Total aggregated assets of the 135 firms: $465 billion.
- 18% of the 135 firms post AUM $3 billion or more; 82% from $250 mm up to $3 billion.
- 99% of the firms receive compensation as a % of AUM; 61% by hourly fees.
- 100% perform portfolio management services; 94% financial planning services.

Large Financial Services Firms

- Total aggregate assets of nine firms: $ 2.54 trillion.
- From PNC Investments 11.2 billion in AUM to Morgan Stanley and Merrill Lynch with $536 and $575 billion in AUM respectively.
- 88% of the employees in the nine firms are also identified as registered representatives of a broker-dealer.

Characteristics of the RIA firms regarding employees' registrations. lines of business, proprietary and principal trades; advisor compensation not paid by clients; material conflicts of interest

- 35% of the RIAs and 100% of the large financial services firms report employees who are registered representatives of a broker-dealer. (Part 1 A 5.B 2)
- 39% of the RIAs and 100% of the large financial services firms report employees who are licensed agents of an insurance company or agency. (Part 1 A 5.B 5)

  These data suggest that insurance sales representatives and registered representatives of brokers dealers may play a significant role in many RIA firms. It raises the question of what impact their sales efforts may have on objective advice. These RIAs have decided to supplement their fee compensation with commission compensation. What we do not know from the data is how prevalent in any particular firm is commission compensation, and how well the firm manages these conflicts of interest, or whether the commission compensation earned is credited back to the client. What we do know is that firms that choose NOT to have advisors who are also registered reps or insurance reps also do not have these conflicts to address.
- 2% of the RIAs and 89% of the large banks report the entity or a related person buy or sell securities from advisory clients or to advisory clients. (Part 1 A 8.A 1)

  This is a clear indicator that "principal trading" plays a minimal role in these RIA firms.

- 17% of RIAs and 78% of large financial services firms recommend securities to advisory clients in which the advisor or related person has some proprietary interests. (Part 1 A 8 A. 3)

  "Proprietary products" play a larger role in RIA firms than does "principal trading". Almost one in five RIA firms report recommending proprietary products. This said, what we do not know from this data is how prevalent in these firms is commission compensation from proprietary products. We also so not know how well the firm manages the inherent conflicts of interest in these products. What we do know is that proprietary products create significant conflicts of interest and firms that choose not to engage in proprietary products do not have the associated conflicts of interest.

- 34% of RIAs and 0% of the large financial services firms exclusively receive fees from clients. (Part 2 5 C, E) Of the 66% of the RIAs that receive other forms of compensation, 52% receive brokerage compensation and 34% receive insurance compensation.

  These data supplement the data (noted above) on the prevalence of commissions within RIAs.

- 76% of RIAs and 100% of the large financial services firms have "a relationship material to their business that creates a material conflict of interest with your clients."

<u>Characteristics of RIA firms with far fewer conflicts. Firms with no registered representatives and insurance agents and that report only receiving compensation from client fees and that also report having no "material relationship" that creates a material conflict of interest.</u>

- 18% of the 135 RIAs (25) report having no registered representatives or insurance agents or receiving any compensation other than client fees or have material relationships that create any material conflicts.

- Firms' total AUM is $ 65.4 billion and 33% of the 25 firms (8), assets of $3 billion or more.

From Part 1A item 11, "Disclosure Information"

The "disclosure" questions in Item 11 involve different levels and varieties of wrongdoing or potential wrongdoing as determined by actions, inquires or involvements of state or federal agencies or authorities. From the survey responses we show the results of twelve of these questions. (See attachment 1.) Below, as examples, we highlight five questions.

	Yes, RIAs %	Yes, Large Fin Firms %
Convicted or pled guilty (nolo contendere) to a felony	0	56
In the past ten years, been charged with a felony	0	56
SEC / CFTC ever found you involved in a violation	1	89
SEC / CFTC ever imposed a civil money violation	1	89
Any other federal / state agency ever found you to have Made a false statement, omission, or been dishonest …	1	89

Each of the large financial services firms answered affirmatively to between five and 22 of the 24 questions in item 11.

Further, based on a review of the Part II descriptions of incidents, each large financial services firm reported between five and 28 infractions and paid between $900,000 and $870,177,500 in fines and restitution as noted in this chart.

Firm Name	Number of Infractions	Aggregate Amount Paid in Fines or Settlements
Ameriprise Financial Services	13	$26,945,000
Edward Jones	7	$68,346,000
J.P. Morgan Securities	11	$870,177,500
LPL Financial	15	$30,514,000
Merrill Lynch	11	$538,478,000
Morgan Stanley	13	$163,290,000
PNC Investments, LLC	5	$900,000
UBS Financial Services	28	$2,250,581,000 [1]
Wells Fargo	12	$74,785,000
Totals:	115	$4,024,016,000

1. Approximately $1.5 billion of the $2.25 billion represents fines from the Libor scandal to U.S., U.K. and Swiss authorities.

Analysis and Discussion

- Form ADV disclosures reveal certain practices or circumstances that entail certain potential or actual conflicts of interest.

- **RIAs.** Five of these practices are: More than one third of RIAs disclose investment adviser representatives who are also registered as insurance agents (1) and registered representatives (2). Almost one in five disclose selling proprietary products. (3) Two thirds (66%) disclose receiving compensation other than fees paid by clients. (4) Also, 76% disclose a relationship "material" to their business that creates a "material conflict of interest with your clients." (5)

- Combined together, only 18% of the 135 firms (25 firms) disclose they have chosen to abstain from and do not engage in any of these practices. Among RIA firms there are considerable differences as to their exposure to conflicts and the prevalence and nature of conflicts. Some firms appear to deem certain conflicts acceptable, while other firms, just 18% in this survey, appear to deem the same conflicts as unacceptable and avoid them entirely.

- These data provide a general description of the firms' practices and compensation policies. These general descriptions are useful. There are differences between firms who choose to sell commission products and those who choose not to do so. Yet, these general descriptions are not comprehensive. They do not provide sufficient information to assess how prevalent and how impactful are conflicted transactions within the firm. They do not indicate how well and how thorough the firm's procedures and policies work to mitigate conflicts. They do not indicate how well clients understand their advisor is recommending a conflicted transaction, or the nature of the conflicted recommendation itself, and/or if genuine informed consent is provided.

- **RIAs and large financial services firms.** While there are considerable differences among RIA firms regarding conflicts of interest, there are even greater differences between RIAs and advisors within the large financial services firms. Direct comparisons need to be made with care because of the differences in the magnitudes of scale. Still some broad points can be made.

- Each of the nine firms (100%) disclose employees who are also registered representatives or licensed insurance agents. 88% of all these employees among the nine firms are also registered representatives. Eight of the nine large financial services firms engage in principal trading, while only 2% of the RIAs do so.

- In item 11 "Disclosure Information," eight of the nine large firms disclosed that the SEC found the firm "involved in a violation," imposed a "civil fine" or a federal or state agency found the firm "or any advisor affiliate" "to have made a false statement or omission, or been dishonest, unfair or unethical." For each of these questions, 1% of the RIA firms disclosed doing so.

- Among the large firms, in their Form ADVs, 115 infractions resulting in fines or restitution of over $4 billion were disclosed. This compares to three infractions among RIAs. Two of the three report fines of $5.700 and $62,500. A third RIA reported paying a fine to Florida "exceeding five figures" and also credits to clients exceeding "five figures."

Conclusions

- The differences between registered investment advisers and broker-dealers are large and reflect their contrasting cultures, structures and roles as either advisers or distributors of products. Investors who seek to execute a transaction can find an experienced and ethical broker-dealer. Investors who seek objective and competent advice need an RIA whose culture is set in the fiduciary duties of the Advisers Act.

- This research illustrates, however, that not all RIAs are the same in their business practices and conflicts of interest. In fact there are material and clear differences between RIA firms that speak loudly about what the firm believes *advice* means. Firms that minimize conflicts espouse a view, consistent with the views of the industry leaders who shaped the Advisers Act, that conflicts are inherently harmful to objective advice and must be avoided if at all possible. This is not easily accomplished. Just 18% of the firms in this survey avoided all of the five practices identified here.

- This view of conflicts is grounded in history and law and espoused by investment advisers and regulators who shaped the Investment Advisers Act of 1940. The SEC today urges adviser to avoid conflicts. This view is also grounded in logic and commonsense and resonates with ordinary investors who every day discern differences between advice and sales. It is in finance and advice where opaque practices remain influential and sales and advice, for many, the same. Such that just 18% of the firms in this survey avoided all of five practices identified here.

- Reviewing a firm's Form ADV takes time. However, the key parts of most ADVs can be reviewed in thirty minutes or less. And by reviewing the Form ADV of an RIA, an investor can see if an RIA firm engages in any of these five practices that bring with them potential or actual conflicts that can impair an adviser's objectivity.

Notes

1. https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=dyn_pr_evrev&wps_key=0c07ba3e-b423-47ba-9b1d-aed758652e35

2. RIA Survey Methodology; the Large Banks

The RIAs were derived from Financial Advisor Magazine's July 2016 RIA Survey & Ranking list. The list includes the top 610 RIAs categorized and sorted by total assets under management, and is available at the following link: http://www.fa-mag.com/userfiles/2016_FA_Issues/July_2016/RIA_Files/jul_fa_RIA2016_Ranking_3.pdf.

Only RIAs with $250 million assets under management were considered, and every 3rd RIA beginning with the first on the list (CAPTRUST) was selected for Form ADV evaluation.

The large firms are Ameriprise, Edward Jones, J. P. Morgan Securities, LPL Financial, Merrill Lynch, Morgan Stanley, PNC Investments, UBS Financial Services, and Wells Fargo.

3. Robert E. PLaze, "Regulation of Investment Advisers by the U. S. Securities and Exchange Commission", http://www.stroock.com/siteFiles/PAFile120.pdf

As Plaze writes on page 31 and 32:

"Fundamental to the Act is the notion that an adviser is a fiduciary. As a fiduciary, an adviser must avoid conflicts of interest with clients and is prohibited from overreaching or taking unfair advantage of a client's trust. A fiduciary owes its clients more than mere honesty and good faith alone. A fiduciary must be sensitive to the conscious and unconscious possibility of providing less than disinterested advice, and it may be faulted even when it does not intend to injure a client and even if the client does not suffer a monetary loss. 175 The landmark court decision defining the duties of a fiduciary is Justice Cardozo's opinion in *Meinhard v. Salmon,* in which he explains that:

Many forms of conduct permissible in the workaday world for those acting at arm's length are forbidden by those bound by fiduciary ties. A fiduciary is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.176

These concepts are embodied in the anti-fraud provisions of the Advisers Act. As the Supreme Court stated in *SEC v. Capital Gains Research Bureau, Inc.*, its seminal decision on the fiduciary duties of an adviser under the Act, "[t]he Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."177

4. https://www.sec.gov/divisions/investment/capitalgains1963.pdf

5. Arthur B. Laby, "Selling Advice and Creating Expectations: Why Brokers Should be Fiduciaries," November 2012, http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/02/LabySellingAdviceCreatingExpectations.pdf

Laby writes on pages 720 and 721:

The first (concern) was that so-called "tipster" organizations were disguising themselves as legitimate advisory organizations.[60] Certain firms providing advice were affiliated with investment banks or brokerage firms and, therefore, had a vested interest in recommending particular securities. Investment banks were securities merchants; they were paid based on the spread between their purchase price and the sale price to the customer. Such institutions were unable to provide objective advice. As one adviser stated, "[A] merchant in securities to be sold at a profit is primarily concerned with moving the wares he has on the shelf that he will make money out of, and therefore is not in a position to give unbiased advice, which we have stated to be the function of the professional investment counsel."[61] The report emphasized that an adviser cannot provide unbiased advice unless conflicts of interest were removed. This concern over biased advice presages the current debate over whether to place a fiduciary duty on brokers and will be revisited shortly...