INSTITUTE FOR THE FIDUCIARY STANDARD

Fiduciary September 2014
September 8, 2014
A Transcript from A Special Webinar

Restoring Investor Trust in Wall Street, with Broker-Dealers and Investment Advisers

Participants Present

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Michael Falk, Focus Consulting Group
Jack Waymire, Paladin Registry
David Armstrong, WealthManagement.com
Knut A Rostad (KR), Institute for the Fiduciary Standard

Text

Moderator: John, I'll turn to you. What's your view? It seems like regulators have an inability to agree on a fiduciary policy at the moment. Can the industry find its own way to fix this problem of trust? And if so, how? Are the incentives that advisory firms work under on the brokerage side too skewed to really foster trust? (3:54)

JT: I assume you're asking John Taft that question?

Moderator: I am.

JT: OK, yes. First of all, I'd like to point out that the distinction between – that the previous panelist made between – quote-unquote Wall Street and RAAs is a false distinction. I agreed with many of the points that you made in your introduction and that Jack made in his comments, but it's important to realize, I run a wealth management firm that does business inside the legal shell of a broker-dealer. More than half of our clients' assets are managed pursuant to investment-advisory agreements where the financial advisers who work for me inside our brokerage firm are acting as investment fiduciaries. Though Wall Street versus RAAs is a distinction that is misleading and it isn't helpful to the conversation we're having, which is about – and the reason I'm on the call – finding a way to more broadly overlay a fiduciary standard on all investment advice that professionals provide to individual investors as a way to improve investor trust and confidence. That's something that the brokerage industry has supported prior to the writing of section 9-13 in the Dodd-Frank Act. So we're on the same page with fiduciary advocates in saying that one way to walk further down the path of restored investor trust and confidence is to come up with a single, unified fiduciary standard for anybody who's talking to individuals about their wealth management activities. Where we disagree with the RAA community is that we don't feel – and as somebody who runs a wealth management firm, I know – that imposing the fiduciary standard as it has evolved around ***40 Act*** investment advisory – discretionary, investment advisory activities – that is not the way to get to a solution. You can't take that particular set of rules and protocols, which work when it comes to discretionary investment and management, and bring it over to the brokerage side of a wealth management firm and say we're going to impose the

same rules on the buying and selling of securities. We're going to impose the same rules on the setting up of trusts, the lending of money, the sweeping of cash into bank-deposit vehicles. It doesn't work. So, we support, a uniform, overlay fiduciary standard, but it has to come along with new rules, which operationalize that fiduciary standard when it comes to brokerage activities other than the investment advisory activities that advisers are providing to their clients. So that's where we stand, and we think that, a fiduciary standard, if we're able to come up with a way to bring it over onto the brokerage side of the equation without compromising client access to products and services, or compromising their ability to choose who they work with, or how they pay for those services. If we can do that, it would be a major win for everyone. (8:17)

KR: This is Knut Rostad. I'd like to jump in here for a minute, and I know I've interrupted you a little bit. But I'd like to add a couple of very specific questions to what I've heard from John on one side, and what I've heard from Jack on the other side. And John, you know, I guess there are two or three things that jump out at me in terms of your remarks. And I'd like you to respond to them.

First of all, your comment regarding the insignificance of whether a broker – or an individual providing advice who comes at it from a brokerage setting or advising setting – I'd like you just to comment very quickly on whether the broker's obligation to the broker-dealer or the issuer is totally irrelevant on this point. I think we forget, sort of, a very basic point. The broker does not exist in law and in practice to be there to advise a client and represent a client. (35:45)

JT: Well, Knut, let me go back to my…

KR: John, let me finish please. As opposed to an adviser who does exist to represent the client. So that's the first question. The second question is in regards to your strong statement that broker-dealers are for a uniform fiduciary standard, and if, what you mean by that, do you think of the standard that has been so clearly articulated by SIFMA over the last three or four years. I go back to their July 2011 letter. That is the second question.

And if that's true then I want to jump in and ask you about three or four points in terms of what SIFMA's position is. And I'd like you to explain to us, and explain to the listeners how those positions can be consistent with the statement or claim that will work in the client's best interest. So, if you could answer those first two questions, then we'll go to the third. I would appreciate it, thank you.

JT: Sure. Well, I'm going to go back to my wealth managers. And when I walk into the office of my wealth managers, I expect them to have one thing on their agenda, and that is helping me manage my wealth. I expect them to have my best interest at heart from the minute I walk into their office to the minute I walk out. OK, but as a practical matter, from a regulatory standpoint, when we talk about a series of portfolios, that they manage for me on a discretionary basis, either directly or through third-party managers, they put on a white hat – your white hat – and they are investment fiduciaries. They're operating pursuant to investment advisory agreements and they are subject to a fiduciary standard. Then we go, and we talk about…huh?

KR: You're talking about your registered brokers on that point?

JT: No, my financial advisers who work for the broker-dealer that I run, and manage money for me discretionarily as registered investment advisers subject to a fiduciary standard. OK? Then we finish talking about my equity portfolios, then we talk about my bond portfolio. Now I invest in municipal bonds. I know a lot about it, I ran a mutual fund company that was a muni-bond company, and I was an investment banker who designed and issued municipal bonds. I know a lot about that area. I don't want to pay anybody to manage my municipal bond portfolio, so I ask my financial advisers to build me a bond ladder, with bonds maturing every year, one to seven years out. I want them to find the best bonds they have in the state of Minnesota where I pay income taxes. And 90 percent of the time my firm owns those bonds in our inventory. So my advisers call me up, and they say 'we own state of Minnesota GO bonds due 2020, here's the price, here's the yield, do you want to buy them?' Yes I do. They buy those bonds from my broker-dealer acting as principle. In violation of a fiduciary standard. They couldn't do that if you impose the 40-Act fiduciary standard on that activity. Does that mean that my broker is just taken off the whole white hat of acting in my interests? And put on a black hat where they're looking to screw me on the trade they just made in my bond portfolio? And now we're going to go talk about my insurance trust. And now we're going to go talk about my loans that secured by my bond portfolio. My point is, that I expect my financial advisers to have my best interest at heart across all those activities, but regulatorily they're fiduciaries only with respect to one of the activities that they engage in on my behalf. That doesn't make any sense. So to answer your question, would they put their hand in the air, and sign up for a fiduciary standard that applied to all those activities? Absolutely. Would they sign up for a fiduciary standard that told them they could no longer construct a bond portfolio made up of municipal bonds that they purchased for me, out of our firm's inventory because that principle transaction was a prohibited transaction. They would not sign up for that fiduciary standard. In one case the right way, in one case the wrong way.

KR: And the reason they wouldn't sign up for that is because in their capacity in terms of the principle trades it's been determined that that is so conflicted that by nature it should not be part of being a fiduciary. They can do that all day long as a broker – and god bless them for doing that – but all one would suggest is that they don't do that as a fiduciary.

JT: Ok, I totally disagree with what you're saying. Because right now – Knut listen – This is where misinformation makes the job harder, not easier. So actually it does turn out, as I'm sure you know, that if you're managing money discretionarily for a client, you can engage in a principle transaction. You can engage in a principle transaction if you disclose to the client that you are, and the client agrees to that trade before it happens in writing. So, you can do that inside a discretionary, investment management account, which points out that a fiduciary standard is not a no-conflict standard. A fiduciary standard is a standard in which conflicts are disclosed and they are not acted upon unless the client accepts and waives the conflict. The mere charging of the feat is a conflicted activity.

KR: John do you get informed, written client consent every time when those conflicts are disclosed?

JT: Any time that a principle trade is made inside a discretionary, investment advisory account, I do. I don't in my bond account because I haven't asked for it. But let's say we said "OK, we're going to impose a fiduciary standard on my broker when it comes to buying me municipal bonds and setting up a bond ladder." And a requirement for that fiduciary standard for that activity operationalize for that activity, is that my client discloses to me, that from time to time I will buy bonds for you, from the

firm's inventory. We will be acting as principle. That is a conflict. Do you accept that conflict? I would say absolutely, all day long. Why? Because I know I will get better bonds at better prices, and better yields if I accept that conflict, than if I require my broker to go out in the marketplace and troll for bonds on an agency basis. So there's an example where it's simple to operationalize a fiduciary standard and apply it to a brokerage activity. It works in my best interest. And if you just go activity, by activity, and perform that work you can get to a fiduciary standard that works in a brokerage context. But if you go over to the investment-advisory world – I'm not done – if you go over to the investment-advisory world and just say we want to apply the one-size-fits-all investment-advisor fiduciary protocol to brokerage activities, it's a non-starter. And that's where you guys are stuck. You won't move off that position.

KR: John, it's not that we are stuck about it. It's been stuck like that for generations and generations. And I think what we are reflecting is that fact. I just want to clarify one point, the disclosure that you're getting, is that a blanket disclosure that you were talking about just now? That's a blanket disclosure, correct?

JT: For what? For the bond account?

KR: Yeah.

JT: It doesn't exist, so we'd have to decide it, but yeah, I would say annually renewable, disclosure and acceptance of the fact that when my adviser is building, making trades in my bond account, they're doing so as principle, they're conflicted. I accept and waive that conflict.

KR: Which the SEC for years said that was inadequate, but has changed their view over time, if you go back to Arlene Hughes, that's their position. Finally, and I know I'm taking up the clock here, but in terms of being specific, in terms of what else – in your view John – is appropriate for fiduciary in the brokerage environment. Is it fair to assume that you agree with the position that SIFMA has put out there as of three years ago, or not. Is that fair or not?

JT: I was the architect of that statement, of course I agree with that. I testified in favor of it in front of Congress.

KR: I know you did, John. I know you did.

JT: Then what's your question?

KR: No, because, John, I didn't want to assume that your position as an individual executive was exactly the same as SIFMA's.

JT: It is. We support a fiduciary standard.

KR: Because I want to touch on about three points on that position, and I think it would be very good if you were able to explain it. And the first point has to do with the position on conflicts of interest, and

in SIFMA's letter they chide the SEC for urging advisers to avoid conflicts of interest. And they go further to suggest that conflicted advice can be advantageous to clients. So that's one point.

The second point is, in terms of precisely what is covered by your notion of uniform fiduciary standard in the SIFMA position, it's very specific about the language that must be used between, from the adviser to the client to be included as being covered by your version of uniform fiduciary standard. And it really comes down to when you use the words: Mr. Jones, I recommend X. And so it's a very narrow view, and as I'd like you to explain why it's appropriate that your adviser can sit in front of a client, and speak for ten minutes, and only have one or two of those minutes hypothetically consistent with SIFMA's view, covered with fiduciary language.

Then I'd like you to explain too, that – I'm almost done John, but this is really good, and you're going to be really helpful in your answers here, I know you are – I wish you could explain where or how it's in the client's best interest, when the adviser – in your view – should be able by contract to basically narrow out and define what is covered by fiduciary, and what is not covered by fiduciary. Because I think when you look at – when you stand back and look at – at SIFMA's point of view, and SIFMA doesn't even say this, that this may entail a fact-finding exercise to determine what parts of the language the adviser-broker has used are covered by fiduciary and what parts are not. I will let you speak, and sort of talk about how those views are consistent with fiduciary standards.

JT: I gotta be honest with you, I forgot the first question. What was the first one again?

KR: The first question is SIFMA defending the importance of…

JT: OK, thank you. Let me use this example…

KR: …and chiding the SEC for encouraging advisers to avoid conflicts.

JT: Alright, let's use a simple example. OK. Ali Baba is doing, is bringing to market one of the largest ever IPOs in history next week. OK? My client walks in the door and says – and this is happening right now at my firm. Demand for shares of Ali Baba are unbelievable. Everybody wants to own it. So, guess what? We are a co-managing underwriter RBC of the Ali Baba initial public offering. Under a fiduciary standard, that looked, smelled and felt like the 40-Act standard, or a no-conflicts rule – which you say SIFMA chided the SEC about – we would have to say, sorry, we, RBC cannot sell you shares of Ali Baba. Why? Because, by definition, in an underwriting, we are a principle, we are conflicted.

KR: Why can't you send them down the hall to your broker?

JT: Knut, we're talking about a fiduciary standard applying to all the brokers at my firm.

KR: Wait, but, John, no one has ever talked about covering every single broker all the time for all their activities.

JT: That's what we support.

KR: That's interesting.

JT: That's the whole point. Now, what I would say, and where SIFMA's coming from when they say, actually engaging in that conflicted activity, i.e. making shares of Ali Baba available to our clients, can serve the best interest of our clients. It's what they want, let's start with that. Ali Baba may appreciate in value significantly over time. Let's go there. And so, allowing them to buy shares from us, may actually be in their interest. Even though by definition we are acting in a conflicted way. OK. That's what that statement is all about. And we're going to run out of time here on the call – I'm gonna run out of time – but that's just one of the many examples. The point is this, Knut, that when it comes to brokerage activities. OK, a fiduciary standard has never been written for, a fiduciary standard has never been operationalized, so that it protects investors while at the same time allowing financial advisers operating in a brokerage context to be fiduciaries. To raise the bar. And all we're saying at SIFMA is:

You need to write new rules if you want to bring the fiduciary standard over from the investment-advisory world and apply it to brokerage activities. Which as I told you, in my case, my advisers do both things for me. So the purpose of the rule is to have one level of investor protection, sitting over the heads of the people who help me manage my wealth. It's not easy to do it. There's no roadmap. We're open to different solutions, but a simple implementation of the 40-Act fiduciary standard in my world doesn't work. That's the point.

KR: John, that's a very good point in being here. I will just say one point very quickly. Your assumption that every representative in your firm, I don't know whether that applies to a brokers, are presumed to be covered. That's a presumption that I don't believe is shared by the vast majority of people out there. In terms of your suggesting that, in a sense, the brokerage function disappears per se under your vision.

JT: It doesn't disappear, but it's subject to a fiduciary standard.

Moderator: I can break in here because I know we're running out of time. I want to make sure that either Jack or Michael who had anything to follow up on this had a chance to speak. (53:49)