NORTHSTAR

White Paper

Using a Fiduciary Wealth Management Process to Deliver Superior, Compliant Investment Advice

How to gain a competitive advantage by implementing a fiduciary-quality wealth advisory process

There is much discussion currently among different trade groups and classes of advisors with respect to the proposed “harmonization” of rules for all types of advisors serving the investing public. While much of the conversation focuses on methods of compensation and which types of advisors are true fiduciaries, the clients’ best interests are getting lost in the debate. NorthStar believes that a well conceived investment process, with controls and compliance incorporated throughout, offers the best solution for clients of broker dealers, RIAs, trust companies and other wealth managers.

This NorthStar White Paper provides an outline for business unit managers on which processes are necessary to provide fiduciary-quality care for clients, irrespective of the outcome of the current political debate in Washington.

1 Introduction to the fiduciary-quality process concept

Wealth management has transitioned from a transaction-based business to an advisory business over the last ten years. Brokerage firms moved from solely providing recommendations on products to creating more holistic solutions for their clients. At the same time, the industry has seen a huge increase in the number of Registered Investment Advisors (RIAs) providing asset management recommendations without specific product sales to retail customers. As a result of these developments, it can be difficult for clients to distinguish between broker dealers and advice providers like trust companies or RIAs – especially given that both types of wealth management service providers are addressing the same basic client needs[1].

As a consequence of the market downturn in 2008- 2009, combined with scandals like the Bernie Madoff investment scheme and alleged inappropriate sales of auction rate securities, regulators began to examine the roles of different types of advisors and the impact of their advice on their clients. One result of this analysis currently under discussion is “harmonization” of standards among the different types of investment advisors. Seeing an opening, organizations from the advisory communities began to lobby the SEC and the Congress to get in front of the discussion and protect their interests.

Notwithstanding the progress of this discussion, one aspect seems certain: within the complexity of the debate it is easy to lose sight of the ultimate goal – the investing public’s best interests. Ultimately, an investor’s best interests are served by a well-designed, understandable, compliance-oriented and a repeatable process that offers the investor the likelihood of the best investment outcomes for their future objectives.

While the discussion around regulatory specifications, advisor compensation methods and supervisory standards progresses, NorthStar recommends that all firms focus on implementing a fiduciary investment process applicable to all investment advice or product-providing organizations. If “harmonization” leads to fiduciary requirements for different types of wealth managers not currently covered, a strong investment advice process will quickly guide them to fiduciary compliance.

2 Issues that prompted the SEC evaluation

In June 2009 the Obama administration published the white paper titled “A New Foundation: Rebuilding Financial Supervision and Regulation” [2]. In this paper, the government stated its goal

[1] In this document, the term “advisor” refers to any wealth management service provider who is providing investment advice to clients. The term “adviser” is only used in the context of the Investment *Advisers* Act of 1940.

[2] Financial Regulatory Reform: A New Foundation; June 2009, Department of the Treasury, page 72.

of establishing a fiduciary duty for broker-dealers that offer investment advice and to harmonize the regulation of investment advisors and broker-dealers. To reach this goal the Securities and Exchange Commission would be given new tools “to increase fairness for investors”.

Since then, the SEC has taken the initiative and is working on guidelines, rules and legislative suggestions. The urgency of the government initiative is not solely driven by significantly underperforming portfolios and the scandals uncovered during the meltdown of the financial markets in 2008 and 2009. This initiative is also driven by a legal framework that has not kept pace with the trends and realities of today’s investment environment.

An analysis of the investment services rendered by investment advisors and broker-dealers shows that their offerings look very similar from an investor perspective. Yet, the quality of the advice differs significantly between advisors – not because of their different regulatory framework, but because of the fiduciary processes [or lack thereof] that they have implemented and are being adhered to by the various firms. Although broker dealers have traditionally shied away from adopting a fiduciary role, they often offer solid advisory programs similar to that provided by RIAs. On the other hand, there are situations where RIAs are just acting as resellers of products for buy side asset managers.

Although the advice offerings across all types of wealth managers may look similar to the investing public, the underlying legal frameworks for investment advisors and for broker dealers have remained significantly different. However; there are very powerful industry trends pushing wealth management providers to an advice model irrespective of their respective legislative bearings.

Given the current discussion about fiduciary duties, it can be assumed that the regulatory framework will require the adherence to some common standards of client care. We believe that implementing a fiduciary-quality process framework today will address investor needs as well as most of all foreseeable changes to regulatory requirements.

Legal Bearings

***What it means to be a fiduciary*[3] -** The concept of a trust goes back to medieval England during the years of the Crusades. Before leaving their estates for the Crusades, English knights left their property and other assets "in trust" with trusted friends (usually members of the church or other lords) – the fiduciaries - for the benefit of the knights’ heirs should they not return.

A fiduciary may be defined as “one who puts their clients’ interests ahead of their own.” Trust companies are fiduciaries by common law. RIAs are held to be fiduciaries as a result of a 1963 Supreme Court finding. Conversely, broker dealers and their registered reps are currently not

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[3] For legal definitions: Black's Law Dictionary 7th ed. (West Group, 1999); for anecdotal references: http://www.webtrust.com/origins.htm

held to be fiduciaries, but are required to recommend products based on the standards of "suitability". (See Appendix 1: Relevant Fiduciary and Investment Process Laws)

Fiduciaries owe two main duties to their clients: a duty of loyalty and a duty of care. The duty of loyalty requires that fiduciaries act solely in the interest of their clients, rather than in their own interest. Thus, fiduciaries must not derive any direct or indirect profit from their position and must avoid potential conflicts of interest. The duty of care requires that fiduciaries perform their functions with a high level of competence and thoroughness in accordance with industry standards.

The regulatory foundation of investment advisors is anchored in the Investment Advisers Act of 1940 **(Advisers Act)**. A subsequent Supreme Court decision clarified that investment advisors owe their clients a fiduciary duty. The fiduciary role of trust companies goes much further back in history as they are fiduciaries by common law. Recent legislation has further clarified aspects of trust operations and the fiduciary obligation of trustees.

Laws pertaining to the operation of pension plans and trust banking have also clarified the role and duties of a fiduciary. These laws have continuously incorporated new investment techniques, (e.g. modern portfolio theory) and serve as a starting point for any fiduciary standards. Also relevant in the context of framing a fiduciary standard are the Uniform Prudent Investor Act (UPIA) from 1994, the Restatement Law of Trusts, the ERISA Federal law from 1974, Management of Public Employees Retirement System Act (MPERS) and the Pension Protection Act of 2006.

Regulatory authorities have issued regulations in the context of the fiduciary legal framework. For trust companies, the most relevant regulations for this analysis are the directions issued by the Comptroller of the Currency for fiduciary investment activities of national banks, known as Reg. 9 or more accurately 12 CFR 9 Fiduciary Activities of National Banks. This is a framework for adhering to the Advisers Act.

Brokers providing investment advice - the definition of "investment advisor" under the Advisers Act excludes "any broker or dealer whose performance of such investment advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore."

Under the Advisers Act, a full service broker who charges a fee, based on the size of the transaction or number of shares traded, is not considered an investment advisor, regardless of whether investment advice is also provided to the customer. On the other hand, by definition, a broker who varies the commission charged based on the amount of advice and consultation given to the customer, is considered to be an investment advisor under the Advisers Act[4]. Thus fee structure would seem to be a determinant of fiduciary obligation.

Yet, the SEC has issued and revised its rules over the last ten years, and still allows broker dealers that offer fee-based brokerage accounts to avoid the fiduciary obligations required of advisors under the Advisers Act. Registered reps have only "suitability" requirements, a standard many feel is looser than that of a fiduciary. "Suitability" requires that brokers only sell investment products that are "suitable" to a client's specific financial situation.

Much has been made of, primarily by the RIA community, the superiority of the "fiduciary" level of care as compared to the "suitability" level of care provided by brokers. On the surface, this is a comparison that the brokerage community has a hard time dispelling, at least on paper. No doubt many broker dealer reps may, in fact, feel they are providing a fiduciary level of care, but they don't get the credit for it by the regulators. After all, when compared to RIA's, brokers have:

- Significantly more onerous licensing requirements.
- More continuing education responsibilities.
- More complex and onerous compliance regimes within their firms[5].

At the end of the day, this discussion, like the discussion on compensation, does not truly identify specific benefits to clients.

While it might be better for clients if there was a clear distinction between brokerage firms and RIAs, the lines have been blurred so as to be indistinguishable. Many broker dealers have parts of their business dual-registered as both an investment advisor and a broker dealer, and then have done the same with many of their registered representatives. This intermingling has been supported by current SEC regulations.

Conversely, the use of an affiliated broker is common among larger advisors and is also

[4] Questions and Answers provided by the OCC with regards to "12 CFR 9 Fiduciary Activities of National Banks".

[5] "Simplistically, although the stacked volumes of statutes and SEC and SRO rules to which a broker-dealer is subject might span three feet in height, investment advisers are subject to statutes and rules that probably span less than three inches."; The Madoff "Opportunity" – T. P. Lemke and S. W. Stone.

permissible under SEC rules. Thus the advisor's broker affiliate can earn commissions on the very trades initiated by the advisor, who also earns a portfolio management fee.

Smaller independent investment advisors often have neither the tools nor access to products in order to fully develop and implement a client's investment strategy, calling into question their adherence to a fiduciary standard. Often, their solutions are limited to the capabilities of the RIA platform provider through whom they clear.

It is under this premise of differing standards of fiduciary quality that the discussion on harmonizing the legal framework has gathered steam with the goal being to resolve the current inconsistencies between broker dealers and investment advisors which provide investment advice.

Potential areas of conflict for brokers – one of the most important considerations when applying a fiduciary duty to an investment advisor business is analyzing potential conflicts of interest. The examples below show that it is very difficult to operate an investment advisory business and apply a fiduciary standard in its strictest sense, whether one is a broker or an RIA:

- **Product distribution** – broker dealers and most banking organizations have been traditionally organized with the purpose of distributing their proprietary products and not supporting an independent, objective fiduciary process.
- **Compensation** – while new advisor-centric services have been added to broker dealer and banking organizations over the years, advisors – especially the top revenue generators - have managed to stick to brokerage-centric commission-based compensation schemas.
- **Product selection** – selecting products for a portfolio and advising clients on managers, strategies and implementation vehicles requires knowledge, research and product access that is costly, can prove difficult to implement and may be subject to biased influence.
- **Oversimplification of advice** – a lot of advisors have simplified their advisory process to a degree that they classify a client into broad categories and provide them with a predefined portfolio without taking financial planning and other investment policy factors into consideration.
- **Affiliations** – most advisors require product information as well as back and middle office support from a custodians, broker dealers, asset managers, and research/market data providers. These relationships require careful management to avoid conflict of interests, and advisors can succumb to these exogenous influences.
- **Lack of resources** – smaller independent investment advisors often do not have the tools, and access to products necessary to develop and implement a client's investment strategy. They are usually limited with regard to their own capabilities and that of their associated Broker Dealer clearing provider.
- **Advice-providing conglomerates** – bigger advice-providing financial conglomerates offer advice out of multiple silos (trust organization, banking private client services,

broker dealer) that do not interact with each other. An investment advisor who is adhering to fiduciary duties may be required to pass a prospect to the part of the organization that would offer the best investment outcome for the prospect's given situation.

Given these inherent conflicts, it's no surprise that many advice-offering parties are compromised as it pertains to true fiduciary duties. However, imposing a broad, vaguely defined fiduciary duty on all advice-providing wealth managers will not alone solve the problem. In fact, applying an un-defined fiduciary duty on all investment advisors will increase the legal liability without providing more clarity or measurable benefits to investors. The solution to this problem is for investment advisors of every type to adhere to a common, well-defined, highly-compliant fiduciary process.

Wealth Management Trends

It's clear that the above described conflicts of interest undermine the bifurcated legal advisory framework, but the wealth management industry has also adopted new practices, products and services that further exacerbate the issue. Clients expect that these offerings and providers are catering to their needs, irrespective of their legal framework. The following list of industry trends have individually come about as a mitigation and reaction to the current fiduciary inefficiencies. However, because they lack a cohesive overarching fiduciary framework, they can create as many problems as solutions.

Investment methodologies

Various tools and best practices derived from academic research started to find their applicability within institutional investment management about thirty years ago and are now considered best practices amongst wealth management professionals.

1. **Open Architecture** – provide investors with the best possible choice of investment managers and not limit these investors to choosing amongst proprietary products.

2. **Modern Portfolio Theory** (MPT) – assess the risk of a portfolio and not the risk of investments individually. Implicitly addressed by MPT are the benefits of diversification of a portfolio.

3. **Financial Planning** – financial planning has become an integral part of any wealth management offering, specifically in the context of providing advice. Financial planning allows an advisor to establish and analyze the cash flow needs of an investor. Unfortunately, a lot of advisors only do risk profiling and asset allocation, but do not provide financial planning as part of their services. Being a fiduciary and an advisor without understanding the specific goals and related cash flow needs of a client can lead

to suboptimal investment advice and erode the fiduciary quality of the client's experience.

4. **Disciplined rebalancing** – eliminate portfolio drift by periodically rebalancing a portfolio against allocation targets.

5. **Creation and monitoring of an investment policy** – monitoring of the investment policy to ensure that targets, constraints and objectives are being adhered to with periodic formal review of the investment policy statement by the portfolio manager.

6. **Simulation of variability of returns** – test a portfolio using analytics to validate that downside risk and volatility of a portfolio are still in sync with an investor's risk profile.

Many advisors, including advisors who are not legal fiduciaries, have adopted these best practices. Investors today are expecting their wealth managers – irrespective of their background - to apply these methodologies. But it's not only about using a tool to implement one or two of these methodologies to satisfy a client's concerns; the tools must be used together and in the context of managing an overarching process. This process ensures that the use of these tools, practices and methods respects the best interests of a client; therefore, they are the primary driver of the advisory process. .

Advisor business models

The traditional discretionary advisory approach as practiced by European Private Banks may be less relevant for the U.S. market as it often requires an advisor to pick individual stocks. The advisory offering that the U.S. market is gravitating towards is in alignment with Modern Portfolio Theory and the implementation of a portfolio along various constraints (e.g. asset allocation, currency allocation, investment restrictions) using investment products such as actively managed strategies, ETFs, alternative investments, derivatives and cash vehicles.

This approach is known within the industry as an "Asset Allocation Program". These programs differ widely with regard to the extent of the advisor's discretion. In a typical asset allocation program, the advisor has discretion to initially invest the client's assets among several managers, and to reallocate the assets as they deem appropriate based on the client's investment profile and prevailing market conditions. Since discretion is not a necessary prerequisite for setting up an asset allocation model, most broker dealers offer attractive and elaborate asset allocation programs of their own.

The big advantage of asset allocation programs is the perceived objectivity of an advisor; e.g. that the manager selection can be discussed with a client and, in the case of underperformance, a decision to "fire and replace" the manager can be mutually agreed upon. The fact that discretion is not needed for operating these asset allocation programs allows broker dealers to effectively circumvent any advisory regulations and compete with investment advisors.

Investors have alternatives

Investors are looking for investment results, trustworthiness and exceptional service when choosing an advisor. If investors feel that their advisor is not providing adequate services or investment results, an investor has the choice of changing the advisor for another.

The brand value of bigger banks and broker dealers has suffered as a result of poor financial performance, mergers and scandals[6]. As a result broker dealers and banks have lost their cachet as a stable, safe haven for advice seeking customers. Independent RIAs, many of whom have adhered to fiduciary best practices, have been much less affected by a diminished reputation and have picked up business from larger organizations.

In the lower wealth tier client segments, there is a trend to replace underperforming advisors with an emerging sophisticated form of self-directed brokerage services supported with easy to use planning, analytics, alerts and automated implementation.

Investment products

Investment products have become both more complex and more risky if not fully understood. They have also become less expensive, relatively effective and more easily accessible. New investment products include:

- New managed investment products, including mutual fund wraps and SMAs.
- Asset allocation programs (from blended life cycle mutual fund wraps to UMAs).
- Passive investment products.
- Single stock diversification.
- Research (the availability of independent research and the ability to access proprietary research).
- Alternative products, e.g. private placements, limited partnerships, principal protected notes, hedge funds and derivatives.

Today's product choices are endless and compelling for specific client situations, but may also require significant advice at the point of sale. Products must be put into the context of a client's overall investment policy.

The product selection process step to determine which investment product to choose is critical to being fiduciary-compliant and requires a true advisor to do the following:

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[6] Source: Price Waterhouse Coopers 2009 Wealth Management Survey, page 23/figure12 – Brand value was considered by wealth management CEO as the 2nd most important differentiation factor (after strength of relationship).

- Disclosure of compensation, fees and other forms of remuneration.
- Validating the suitability of product.
- Validating the appropriateness of product.
- Verifying the optimal fit of a product when selling the product and as part of a client review process.

There will be always risks involved in investing into any type of investment product. However, following a repeatable, structured best practice product selection process allows advisors to limit risk and still justify the product choice in case of underperformance, thus limit the thread of litigation.

Compensation of advisors

Advisors need to be appropriately compensated. Compensation drives behavior and can easily lead to conflicts of interest if such compensation is setup incorrectly.

The trend in the industry is to charge a fee based on assets under management, no matter the form of the advisor's business model. Broker dealers are also trying to find new ways to charge fees. The current industry debate focuses on the fee model of RIAs versus the commission model of broker dealers. This is unfortunate, because compensation should be used *primarily* as a tool to support any management strategy – in this case the adherence to a fiduciary quality investment process. If discussed outside the context of the fiduciary processes and the objective of motivating an advisor to seek the best possible investment outcome for his/her clients, the advisor compensation discussion not only misses the point, but acts to fuel the fire.

The Burden of Compliance

Rules regulating broker dealer organizations force brokers to operate under a significantly more onerous compliance regime than investment advisors. Avoiding this compliance exposure is one of the main reasons that brokers leave their employer and start or join an investment advisory business. This trend cannot be in the interest of investors if becoming an investment advisor is perceived by financial professionals as an effective way to avoid dealing with an intrusive Compliance department.

Introducing Business Processes to Wealth Management

Guided by management consulting firms and research on their own, major banks and broker-dealers have introduced business processes in their wealth management areas. As in other industries, business processes usually adhere to some basic criteria:

- Repeatability – if a client would be advised twice, or by different advisors in the same firm, this client should receive the exact same treatment the second time as the first time.

- Auditability – all process steps and advice outcome need to be logged and filed, and should be retrievable for later review.
- Flexibility – all clients have slightly different needs. The process has to address the personalization of the advice without losing its integrity.
- Guidance – the fiduciary investment process should assist the advisor in critical complex steps, such as planning, product selection and risk profiling.
- Division of labor – the concepts of competence centers, advisory teams and supervision allow for higher standards of competence, unlock efficiencies and ensure adherence to a process "playbook".

Other less critical aspects of a fiduciary investment process relate to creating brand value (proposal and reports with branding), efficiency and leverage of competence centers.

The introduction of processes to wealth management is important as traditionally the industry relied on individual practitioners with very little management guidance except revenue goals and compliance guidelines set by regulators. Fiduciary standards help wealth management organizations measure their fiduciary responsibility and ascertain their compliance with such standards.

3. The Fiduciary Process

Benefits of the fiduciary process to clients

Given the legal context, conflicts of interest, and current wealth management trends, it becomes immediately clear that acting as a fiduciary without a defined fiduciary process fails to deliver for clients. In doing so, firms could be obligated to send their clients to their less-expensive competitors down the street. They might have to turn down certain types of relationships, such as those that trade infrequently or hold large cash positions. [7]

The primary benefit a client should gain from a fiduciary process is in knowing that the recommended solutions and products are in their best interest based the clients objectives and risk tolerance. These factors must be analyzed in a non-biased process without conflicts of interest. As such, investors should be confident that the recommendation they receive is not tainted by:

- Compensation that favors one solution over another.
- Product selection that has been biased in the favor of specific providers, either with or without financial rewards[8].

[7] It should be noted that trust companies are willing to turn down inappropriate accounts for a variety of reasons. There are few examples of RIAs acting in a similar manner.
[8] For example, investment products of an affiliated organization.

- Oversimplification or superficiality of advice, especially advice or products not specific to an individual client's situation.

Any advisor that utilizes a process that eliminates potential conflicts and inappropriate advice on products improves the fiduciary-based wealth management experience for the client. Implementing a fiduciary process framework now will allow wealth managers to be prepared for these more-stringent requirements should they develop.

At the same time, the fiduciary process will allow a wealth manager to incorporate the benefits of the compelling trends in wealth management without conflict.

Above all, a fiduciary process allows wealth managers to provide a logical, client-centric and auditable investment advisory offering to their clients, thus distinguishing themselves from those who are not employing fiduciary standards. By smartly deploying a fiduciary process, organizations can leverage the benefits of being both a broker dealer and being an advisor, while offering their clients a best-in-breed wealth management process.

Adopting Fiduciary Process Standards

As outlined above, implementing a fiduciary process will provide an infrastructure to allow a wealth management organization to adapt more easily to coming fiduciary standards and related requirements, define customer service standards, set compensation models and audit the investment process. It also allows an organization to articulate a competitive advantage over classic broker dealer organizations that have not implemented such processes. A fiduciary standard can be marketed as a differentiated "Fiduciary Quality Client Care" seal of approval.

Fiduciary standards

Best practices related to the role of a fiduciary in an investment advisory relationship have been well documented and agreed upon. There are several studies which outline standards for a fiduciary process framework[9], most of which are very similar to each other. These process frameworks emphasize the importance of investor profiling, asset allocation, investment policy creation, product selection, disciplined rebalancing and monitoring of the investment policy.

[9] The standards set by the "Foundation for Fiduciary Studies. Center for Foundation for Fiduciary Studies and Fiduciary Analytics" are used in this white paper as an example of fiduciary standards. Source: Prudent Investment Practices, A Handbook for Investment Fiduciaries, Foundation for Fiduciary Studies, 2003 Center for Fiduciary Studies

However, many wealth management firms, specifically broker dealers, are not adhering to these standards[10].

[10] It should be noted that the Uniform Standard of Care Uniform Fiduciary Standards of Care is based on the following seven “Uniform Standards of Care”: 1 Know standards, laws, and trust provisions. 2. Diversify assets to specific risk/return profile of client. 3. Prepare investment policy statement. 4 .Use “prudent experts” (money managers) and document due diligence. 5. Control and account for investment expenses. 6. Monitor the activities of “prudent experts.” 7. Avoid conflicts of interest and prohibited transactions.

Uniform Fiduciary Standards of Care – Process Steps	
1. Analyze a client's current investment position.	
	Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements
	Fiduciaries are aware of their duties and responsibilities
	Fiduciaries and parties of interest are not involved in self-dealing
	Service agreements and contracts are in writing, and do not contain provisions that conflict with the fiduciary standards of care
	There is documentation to show timing and distribution of cash flow and the payment of liabilities
	Assets are within the jurisdiction of U.S., and are protected from theft and embezzlement
2. Diversify the client's portfolio.	
	A risk level has been identified
	An expected, modeled return to meet investment objectives has been identified
	An investment time horizon has been identified
	Selected asset classes are consistent with the identified risk, return and time horizon
	The number of asset classes is consistent with portfolio size
3. Formalize Investment Policies	
	There are details to implement a specific investment strategy
	The IPS defines duties and responsibilities of all parties involved
	The IPS defines diversification and rebalancing guidelines
	The IPS defines due diligence criteria for selecting investment options
	The IPS defines monitoring criteria for investment options and service vendors
	The IPS defines procedures for controlling and accounting for investment expenses
	The IPS defines appropriately structured, socially responsible investment strategies (when applicable)
4. Implement Investment Policy	
	The investment strategy is implemented in due diligence
	The fiduciary is following applicable “Safe Harbor” provisions (when elected)
	Investment vehicles are appropriate for the portfolio size
	A due diligence process is followed in selecting service providers, including the custodian
5. Monitor and Supervise	
	Periodic reports compare investment performance against appropriate index, peer group and IPS objectives
	Periodic reviews are made of qualitative and/or organizational changes of investment decision makers
	Control procedures are in place to periodically review policies for best execution, soft dollars and proxy voting
	Fees for investment management are consistent with agreements and the law
	“Finders fee”, 12b-1 fees, or other forms of compensation that may have been paid for asset placement, are appropriately applied, utilized, and documented

The fiduciary investment process is an implementation of these best practice investment concepts given fiduciary standards. Fiduciary standards help wealth management organizations measure their fiduciary responsibility and ascertain their compliance with such standards.

There are multiple approaches to derive and implement an investment strategy. Academic research and investment professional associations recommend a structured top-down investment methodology, which has become the standard. This approach has proven to deliver the most value to investors over medium to long term investment horizons, is auditable, and allows for delegation of competencies. As a result, it is also scalable and aligned with standards on the institutional investment management side of the house.

The investment process includes the following core concepts:

- **Financial Planning** – use of financial planning tools to determine a client's cash flow requirements and validate the downside risk of the chosen asset allocation.

- **Creation of an investment policy** – define the investment strategy, which includes targets, constraints and objectives, in writing and have the client consent to it.

- **Application of MPT** – assess the risk of a portfolio and not the risk of investments individually. Implicitly addressed by MPT are the benefits of diversification of a portfolio. Use of tools to support the quantitative approach to investment management, e.g. use of return simulation analytics.

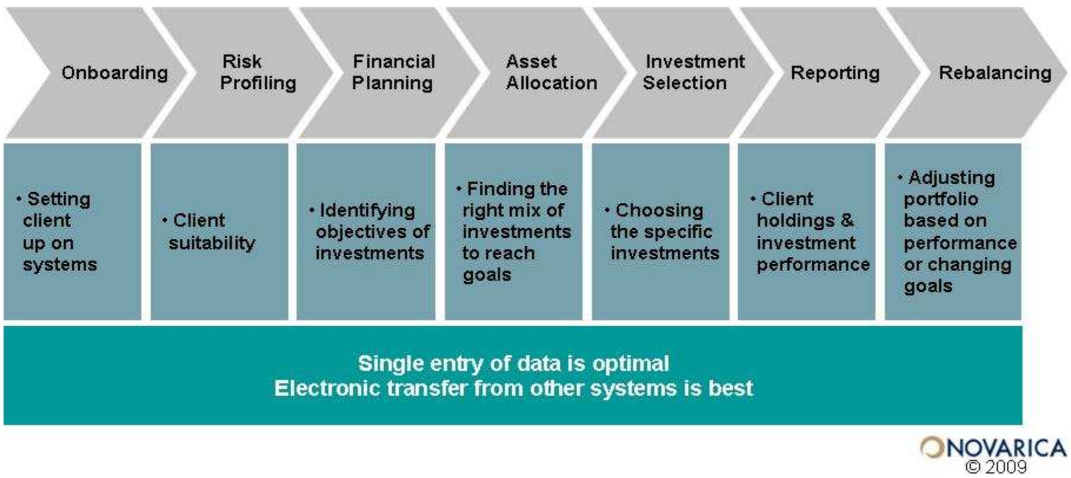
- **Provisioning of a solid product line up –** use of the best active managers, passive strategies to cover core asset classes, augmented with wealth tier specific alternative investments to take advantage of tactical market dislocations. The investment vehicles (UMAs, mutual funds, separately management accounts, ETFs, limited partnerships, etc.) need to be aligned with the wealth tiers that are being serviced. Active strategies are subject to constant review and due diligence.

- **Monitoring of the investment policy and disciplined rebalancing** – monitoring of the investment policy to ensure that targets, constraints and objectives are being adhered to, periodic formal review of the investment policy statement by the portfolio manager and elimination of portfolio drift by periodically rebalancing a portfolio against allocation targets.

Additional investment concepts can be added for servicing client segments with specific needs like active tax management, single stock management, cash management and life cycle services (e.g. multi-generational planning, philanthropy, loans and insurances).

Once a firm has decided to implement a fiduciary-quality process to gain the best outcomes for clients, they cannot go half-way. The firm must first develop a workflow that represents the proper steps to ensure the desired outcome. Appropriate technology must be in place to ensure that each and every client goes through the required steps of the fiduciary process. In this regard, technology can act as an enabler of processes with workflows that support the fiduciary process in a consistent and repeatable fashion. Technology becomes the “traffic cop” for adherence to the fiduciary standard, providing audit trails and checklists. As outlined in the diagram below, it should be viewed not as a stand-alone tool, but rather a continuum of a compliant investment process, which must become the DNA of the firm.

The fiduciary process must begin as soon as an investment firm has identified a new client. The following graphic represents the Novarica[11] straight-through wealth management process of handling clients. In order to maintain a fiduciary-quality client relationship, no step in the process may be omitted. The sequence of the steps might change depending on what information is available to the advisor and the specific circumstances of a client, the market conditions or a portfolio.



Other analysts offer different variations on the process. What is most important is that the process be rigorously adhered to.

The best solution for firms is to install a technology solution that respects and adheres to the fiduciary-quality process for clients. The features of such a technology solution can best described as a set of capabilities.

[11] Novarica is a wealth management research and consulting firm in NYC.

I. Onboarding and Risk Profiling

a) **Prospecting & Client Profiles** - capturing a client profile and funneling the profile automatically to all fiduciary process steps that depend on the information. The profile consists of demographic, risk, relationship, and investment preferences and constraints.
b) **Proposal Generation and Document Management -** centralizing wealth management data and document generation to ensure that all client-facing proposals and reports are generated in a compliant, repeatable way. The integrity of the proposals ensures that asset allocation, product selection, financial planning proposals and follow-on client reviews are consistent with each other. Centralized retention and retrieval of documents is also critical.
c) **Financial Assessment -** analysis of the client's current financial situation and wealth scenarios projections which includes the capability to capture portfolio and net worth including external assets and liabilities.

II. Financial Planning and Asset Allocation

d) **Asset Allocation** - personalizing asset allocations automatically created through either optimizers or models considering client specific circumstances like risk, investment constraints, objectives and preferences.
e) **Financial Planning** – creating a financial plan consisting of multiple goal specific scenarios around retirement planning, education planning, major event planning and estate planning. The ability to consider tax effects is critical.
f) **Investment Policy Statement -** creating and updating an auditable investment policy statement. The major aspect of a good investment policy statement is that attributes must to be captured in a way that portfolios can be monitored against the investment policy statement.

III. Investment Selection

g) **Product Research & Selection** – access to a product catalog to research, locate, track and compare products for the purpose of client and advisor education, conducting due diligence, understanding product procurement and the verification of investment progress and returns.
h) **Portfolio Construction** – portfolio implementation with consideration of investment policy, suitability, eligibility asset allocation rules and constraints.

IV. Reporting and Rebalancing

i) **Client Wealth Management** – servicing clients and portfolios, including rebalancing, add cash, and raise cash capabilities and maintenance of householding relationships and profiling information.
j) **Client and Performance Reporting** –reporting on investment status and progress in meeting client goals and objectives. Review portfolios and portfolio performance vis-à-vis planning objectives, investment policies, market research, proxy voting and manager and asset allocation attribution.
k) **Alerts** – monitoring investment products, portfolio performance, investment policy and compliance.

l) **Invoicing** – calculating, invoicing and tracking of fees, commissions and other charges.

What is most important is that the process be rigorous and adhered to by all advisors. No matter the platform or system used, the system should ensure that the process is replicable for all clients served by all advisors. Exceptions from the process represent compliance and liability risk, and so must be quickly escalated to principals or supervisors for evaluation and approval.

In the future, fiduciary handling of clients should be synonymous with use of a strong process that optimizes client results while maintaining a high level of client care. It is the quality of that process, not the labels and compensation methods, which, at the end of the day, will result in a loyal and satisfied client.

4. Conclusion

Implementing a fiduciary investment process for clients will be necessary to compete going forward, no matter the outcome of the current regulatory debate. Such a process will provide an infrastructure to allow a wealth management organization to adapt more easily to the potential fiduciary standards and related requirements, define customer service standards, audit the investment process and effectively manage compliance.

By adopting a fiduciary-quality investment process, a broker dealer will be able to claim a competitive advantage over organizations that have not implemented such processes, thereby claiming equal footing with an RIA or trust company that has such a process.

In the end, irrespective of the outcome on Capitol Hill, firms that adopt and embrace strong fiduciary standards into their wealth management process will achieve fiduciary-quality outcomes for their clients, which is what the debate should be about after all.

Please see "Using a Fiduciary Wealth Management Process to Deliver Superior, Compliant Investment Advice – A Case Study " for an implementation suggestion, as well as a thorough "A Day in the Life of an Advisor" example showing how the NorthStar Desktop enables advisors to satisfy these fiduciary standards within the Advisory Lifecycle.

5. Appendix

Relevant Fiduciary and Investment Process Laws

Common Law Considerations – "Prudent Man Rule": The Prudent Man Rule is based on common law going back to an 1830 Massachusetts court decision - Harvard College v. Armory, 9 Pick. The Prudent Man Rule directs trustees "to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested"[12].
The Prudent Man Rule requires that each investment be judged on its own merits as isolated investments in a portfolio may have been imprudent at the time of acquisition. However, as a part of a portfolio designed under a strategy, e.g. a hedge fund, the investment could be prudent. Thus, a fiduciary may not be held liable for a loss in one investment.
Since the Prudent Man Rule was last revised in 1959, the wealth management industry has changed (see section 3, trends). Modern Portfolio Theory has introduced and proven the concept of diversification. Hence, the interpretation of the Prudent Man Rule has given way to the "Prudent Investor Rule".

Investment Advisers Act of 1940 – Regulated by the SEC. Although the Investment Advisers Act does not include the phrase "fiduciary duty," the landmark 1963 Supreme Court decision in SEC v. Capital Gains Research Bureau recognized that, as a matter of law, investment advisors owe a fiduciary duty to investors by virtue of state common law.[13]

Restatement Law of Trusts – Removed many Common Law investment restrictions on Trustees and made fundamental alterations to formerly accepted prudent investment criteria, e.g. that the standard of prudence must be applied to the entire portfolio to include all the trust's assets. It also established the trade-off between risk and return as the fiduciary's central concern. But it also eliminated restrictions on investment types in achieving objectives of the trust and incorporated diversification into the definition of prudent investing.

Uniform Prudent Investor Act (UPIA) – This regulation superseded the "Prudent Man Rule". This approach allows fiduciaries to utilize modern portfolio theory to guide investment decisions and requires risk versus return analysis. Therefore, a fiduciary's performance is measured on the performance of the entire portfolio, rather than individual investments. Based on the "Prudent Investor Rule, "a legal doctrine providing guidance to investment managers to manage an investment portfolio in a legally satisfactory manner."

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[12] Wikipedia: http://en.wikipedia.org/ - see entry for the "Prudent Man Rule.
[13] SEC v. Capital Gains Research Bureau, 375 U.S. 18 (1963).

Laws applicable to instutional asset management (e.g. pensions) defining fiduciary practices

ERISA – Federal law from 1974 to set standards for pension plans. This law forced full disclosure to plan participants and established standards of conduct for plan sponsors ensuring all participants would receive full benefits. At the same time it requires trustees to place participants' best interests first and encourages fiduciaries to adopt written policies.

Management of Public Employees Retirement System Act (MPERS) - MPERS was introduced in 1997 and relates to state enacted legislation that defines the fiduciary conduct for state, county and municipal retirement plans. It tries to harmonize standards for trust management across states and outlines powers of trustees, standards for delegation of duties and the definition of a fiduciary.

Pension Protection Act of 2006 – Pension Protection Act of 2006 (PPA), signed into law on August 17, 2006, is one of the most important pension legislation in over 30 years. It makes sure that advisors must acknowledge fiduciary status in writing, disclose any conflicts of interest and all forms of compensation, have an 'advice model' showing criteria for making recommendations, and it forces fiduciaries to set in writing specific fee levels[14].

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