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FAMILY OFFICES

Not All Advisors Are the Same – How Can You Tell the Difference?

By **Maria Elena Lagomasino,** Chief Executive Officer

Over the last dozen years in wealth management I have seen much change in the industry, (some of it good and some not). In particular, I have seen a blurring of the lines that once existed between firms selling investment products and those advising on their merits. Regrettably, our regulatory agencies have failed to stay abreast of this change by not requiring banks and broker-dealers to adhere to the same fiduciary standard which has always applied to investment advisors.

The frog story

The changes in the industry were subtle, much like the frog story: A frog was placed into a container of cool water. The cool water was in a pot on a stove. Unfortunately for the frog, the water didn't stay cool for long. "Why didn't the frog jump out?" you might ask. Because, the water heated up little by little to a boiling point. By the time the frog realized his predicament, it was too late.

How did the wealth management industry change so dramatically?

Starting back in the Great Depression, laws separated banks and brokers. Three separate regulatory schemes existed to govern three separate wealth management functions— (i) banks taking deposits and making loans; (ii) brokers creating and selling securities; and (iii) investment advisors managing clients' money and advising clients.

When the law separating banks and brokers was repealed in 1999, banks and brokers were allowed to merge—and they did. Brokerage rules and a brokerage mindset—otherwise known as a "sales culture"—swept through the banks, eventually overtaking the fiduciary culture which had prevailed in the banks' private banking groups.

In effect, what had been separate activities—advising families from the families' perspective (the fiduciary culture) versus selling investment products (the sales culture)—became one. Many wealth management institutions blurred the distinction by utilizing the term "advisor" for individuals who were actually engaged in the activity of selling investment products. As a result, advocacy and fiduciary obligations to clients were trumped by the push to sell more products to clients and as a result make more money from clients.

Though many private bankers sincerely intend to put clients' interests first, it has been my personal experience that the new sales oriented business model trumps words and good intentions.

The muddy middle

The real issue is that advice that is in a client's best interest and sales of products to customers are not the same and are in many respects incompatible—it's like comparing apples and oranges. It's okay to advise and not sell products; it's okay to sell products (as long as it is clear that it's a sales relationship) if you are not also advising on them. But it's not okay to wrap sales of products in a veil of "advice" that is not in the client's best interest.

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Families that started working decades, or even generations ago, with private banking groups which acted in their clients' best interest—as fiduciaries—now find that their relationship with their wealth manager has changed. These relationships have evolved to be one between a customer and salesperson rather than a fiduciary relationship of trust and loyalty to the client. Many clients are unaware of this change—and it costs them dearly.

As different as apples and oranges

If I had to choose two words to convey the stark contrast between different types of 'advisors' it would be these: 'fiduciary' and 'suitability.' Understanding these two words will give you the power to understand who is your advocate and who is selling to you. The differences between 'fiduciary' and 'suitability' are as profound as the differences between apples and oranges. The advice given, activities performed on behalf of the client, the standards to which the advisor is held—all vary between 'fiduciary' and 'suitability'. In essence they are completely different business models, both providing 'advice'.

You may have read that in the upcoming financial reforms there is a movement to extend the 'fiduciary standard of conduct' or 'fiduciary duty' to brokers and insurance companies who 'advise' investors. Investment advisors have long been bound to adhere to this fiduciary standard and to abide by the core principles of fiduciary duty:

- Put the client's interests ahead of the interests of the advisor
- Act with prudence; that is, with the skill, care, diligence and good judgment of a professional
- Do not mislead clients; provide conspicuous, full and fair disclosure of all important facts
- Avoid conflicts of interest
- Fully disclose and fairly manage, in the client's favor, unavoidable conflicts

In addition, registered investment advisors have a duty to seek to control expenses (such as brokerage commissions) on behalf of their clients and must disclose all compensation they receive from all sources in writing, providing their clients a way to understand if there are any conflicts of interest between the advice they are receiving and the interests of the advisor.

The "suitability standard" is a lower level of conduct that brokers, as salespeople, are required to meet—and the one that most private banks are now regulated under. It is a sales standard. Suitability for brokers requires only that what they sell is a type of security that is not 'unsuitable' for your goals—for example, this stock fund or another stock fund if your goal is equity market exposure. But under the suitability standard of conduct, they can sell you the fund that pays them the most compensation, with the highest expenses—even if there is another one with reasonable expenses that would be better for you—and that's perfectly legal under this 'suitability' or sales standard. In other words, they don't have to put your interests ahead of their own—or their firm's. They don't have to disclose what they and the firm make on the transaction. They are supposed to disclose conflicts but don't have to avoid them or to manage conflicts in your best interest. Under the suitability standard it can be very difficult for clients to understand and interpret any potential conflicts of interest.

Clear Differences in Conduct: Fiduciary Duty and Suitability

Conduct required	**Fiduciary Standard**	**Suitability Standard**
	Registered Investment Advisor	**Broker**
Where found	Registered Investment Advisory firm	Bank, brokerage firm or insurance company
Titles used	Registered Investment Advisor *(only an investment advisor registered with the SEC or a state may use this title)*, financial advisor, investment or financial counselor, investment or financial consultant, wealth manager, wealth advisor	Registered representative, sales associate, broker, private banker, financial advisor, investment or financial counselor, investment or financial consultant, wealth manager, wealth advisor
Regulated by	Securities and Exchange Commission (SEC), a government regulatory agency	Financial Industry Regulatory Authority (FINRA), the self-regulator for brokers, made up of broker/dealers
Standard of conduct required	Fiduciary duty: legally required to put clients' interests first at all times; act with prudence; that is, with the skill, care, diligence and good judgment of a professional; do not mislead clients; provide conspicuous, full and fair disclosure of all important facts; fully disclose any conflicts. Seek to control expenses and disclose all fees or costs to the client in writing. Monitor investments on an ongoing basis.	Suitability: a sales or commercial standard; does not require that salesperson put clients' interests first. May be contractual obligation on part of employee to put the firm's interests first; in most cases, salesperson can put self-interest ahead of clients' interests. Caveat emptor—"let the buyer beware." Must disclose material facts and conflicts of interest but not required to avoid conflicts of interest or to manage conflicts of interest in the clients' favor. Not required to control expenses or even disclose all compensation.
Type of relationship	Client	Customer
Potential conflicts	Must fairly disclose and manage conflicts of interest.	Sales of firm's products, fees earned by firm as well as individual broker; higher fees for some products or investments—which affect an investment's performance. Commission compensation. Sometimes competition for top salesperson to earn special trips. In some cases, must attain sales goals for certain products in order to maintain employer benefits (such as health insurance).
What if there is a problem or disagreement?	*Investment advisor is held to a higher, fiduciary standard as described above.*	*Broker's need only show that an investment was "suitable" as described above.*

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What is the Difference in Business Model? In Dollars, the Difference is Extraordinary.

To put it in concrete terms, one securities analyst projects that, if the fiduciary standard of conduct were extended to brokers who provide advice to investors, it "could cost a firm like Morgan Stanley Smith Barney as much as $300 million, or about 6 to 7 percent of this year's expected earnings." [1]

To put it another way, if that firm had to act in the best interest of the clients it advises, under the fiduciary standard of conduct rather than the suitability standard that brokers operate under, it would earn that much less because certain practices that are acceptable under the suitability standard, including taking fees from parties other than clients or distributing products that are manufactured by the firm itself, would be less viable under a fiduciary standard. In addition, they would have to be disclosed in writing and clients would be less accepting of these practices given the inherent conflicts that exist.

Most importantly, a big part of the $300 million charged by brokers are the fees and commissions paid by families that, under a fiduciary standard, they wouldn't necessarily have to pay. That's $300 million in one year for one large brokerage firm. That is $300 million that is not going to work for families it 'advises' or for the heirs and philanthropic causes they may want to endow.

However, the problem is not simply what a brokerage firm earns in extra fees and commissions from customers; it's the quality of the advice and the products that it sells to you. In addition to those extra fees, the advice may not be in your best interest, the products may not be in your best interest, and may perform poorly because of their higher fees. And, frankly, such advice and solutions may not help you to attain your goals as well as those recommended by someone who is acting as your advocate.

No matter what the words are, if the business (economic) model is built around selling proprietary products or being paid to distribute someone else's products, then the clients' best interest is secondary to the economics. My experience is that THE only way to be a fiduciary is to be paid that way—paid to put the interests of the families first.

And that is why it is so important for you to know the difference between a firm that acts as your advocate—that works for you, on your behalf, with a fiduciary duty to you—and one that isn't required to.

How can you make sure your advisor is working for you, as your advocate, rather than in their own or their firms' interest? Do a fiduciary review. Ask these questions and get the answers to each of the questions, in full, in writing:

- Are you a registered investment advisor under the Investment Advisers Act of 1940?
- Will you be working for your firm, for yourself or for me as my advocate at all times?
- Are you obligated to put my interests before your own or your firm's, at all times, as a fiduciary to me?
- Do you promise to provide conspicuous, full and fair disclosure of all important facts relating to the product or recommendation?
- Will you disclose conflicts of interest?
- Will you fully disclose in writing, all fees, compensation and expenses that you or your firm receive from me–and who else is paying you to recommend products I buy from you?

If they are not willing to answer "yes" to each of these questions then the firm is not willing or able to work for you, in your best interest as your advocate. It's as simple as that.

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[1] *Tara Siegel Bernard, The New York Times, March 3 2010, "Trusted Adviser or Stock Pusher? Finance Bill May Not Settle It"*
http://www.nytimes.com/2010/03/04/your-money/brokerage-and-bank-accounts/04advisers.html?ref=business,there

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