August 29, 2010

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The Need for a “Harmonized” Fiduciary Standard

On July 21, 2010, H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act), was signed into law. Section 913 of the Act calls for a study followed by new regulations of broker/dealers and investment advisers. The study is required to document specific differences between the broker/dealer suitability standard and the investment adviser fiduciary standard. The suitability standard prohibits the sale of inappropriate investments, while the fiduciary standard requires that all investment recommendations be in the customer’s best interest. It is evident that the two standards are materially different, but the study is required to determine their relative effectiveness and to find legal or regulatory gaps, shortcomings, or overlaps.

This paper addresses the action that the SEC is required to take after the study is concluded. Subsection 913(g) provides a summary of the SEC’s post-study mission:

“The Commission [SEC] may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers ....”

This provision of the Act raises a number of questions that the SEC is expected to answer so that regulations can be effectively implemented. We do not attempt to answer these questions, but instead leave them to others more familiar with the subjects. The questions are:

1. What constitutes “personalized investment advice” referenced in the statute? What is excluded?

2. Does the definition of “retail customers (and such other customers as the Commission may by rule provide)” include participants in participant-directed, employer sponsored retirement plans [such as 401(k)], small business owners, and individuals acting as trustees or custodians, or with power of attorney, for individuals?
3. What happens in cases where the “standard of conduct” for broker/dealers is more stringent than “the standard applicable to investment advisers”?

In carrying out this mission, the SEC is not obligated to look beyond the Investment Advisers Act of 1940 (“40 Act”). However, brokers and advisers and/or their retail customers also may be responsible for investments subject to other fiduciary Acts, and the SEC should incorporate in its analysis the fiduciary standards defined by these other Acts:

- **ERISA** (Employee Retirement Income Security Act of 1974)
- **MPERS** (Uniform Management of Public Employee Retirement Systems Act)
- **UPIA** (Uniform Prudent Investor Act)
- **UPMIFA** (Uniform Prudent Management of Institutional Funds Act)
- **Internal Revenue Code** (for IRAs).

Overlapping fiduciary regulations and associated case law could leave the financial services industry and their customers hopelessly confused unless a single “harmonized” or “uniform” standard can be applied in the management of any investment fiduciary decision. By adding broker/dealers to this complex environment, we should recognize both the potential for additional customer confusion and the impact it may have on broker/dealers.

The Foundation for Fiduciary Studies presents the 2010 Fiduciary Standard as a framework that can be adapted to each of these complex regulations, while maintaining a consistent language that is understandable by retail customers. The 2010 Fiduciary Standard is written in plain English and contains a decision-making process that is sufficiently robust to be adapted to a variety of fiduciary engagements and regulatory requirements. The Standard defines a decision-making process that advisers can use in whatever type of client or jurisdiction the adviser operates.

A good illustration of how the 2010 Fiduciary Standard is “harmonized” with existing fiduciary Acts (40 Act, ERISA, UPIA, UPMIFA, and MPERS) and IRC is the requirement that a fiduciary demonstrate their “procedural prudence”—the details of their decision-making process. Procedural prudence raises three related questions:

1. What constitutes the scope and breadth of activities that constitute procedural prudence?

2. Where do generally-accepted investment theory and industry best practices converge to define procedural prudence?

3. Are there consistent references in legislation, regulations, regulatory opinion letters and bulletins, and case law that substantiate a particular dimension of a procedurally prudent process?

The answers to these questions require a variety of expertise. It is for this reason that the Foundation was established in 2000: To provide a ways and means to bring together diverse industry experts to mine the answers to these questions, and then to build a consensus through speaking, teaching, and writing.
The Four Pillars of the 2010 Fiduciary Standard

The Foundation’s 2010 Fiduciary Standard is based on Four Pillars:

1. Principles
2. Process
3. Prudence

Pillar #1 - Principles:

Generally speaking, fiduciary standards are defined in terms of principles as opposed to rules, which impose on the fiduciary the requirement to act in the best interests of the customer. There is relatively little specific “black-letter law” (rules) that govern the conduct of fiduciaries. It’s been demonstrated time and again that rules-based governance is inferior to principles-based governance. Instead, the fiduciary standards are based on simple principles supplemented by industry best practices, regulatory opinion letters, and case law.

Pillar #2 - Process:

As previously mentioned, the fiduciary is required to demonstrate the process that was followed in the management of investment decisions.

A good illustration of process involves the use of proprietary and commission-based products. The Act included an exception that would allow fiduciary advisers to use such products. However, the adoption of a fiduciary standard would have made such a carve-out unnecessary. Under existing fiduciary Acts, no product or strategy is considered imprudent: it’s the decisions surrounding the implementation and monitoring that determines whether a particular product or strategy meets a fiduciary standard. Therefore, a no-load mutual fund from an unaffiliated fund family can just as easily trigger a fiduciary breach as a proprietary product if it can be demonstrated that neither product underwent sufficient due diligence during the implementation and monitoring phases of the investment process.

One of the many lessons we have learned during years in the industry is that simple is preferable to complex. Therefore, a good starting point for defining a process for a “harmonized” fiduciary standard would be a straightforward, five-step process:

Step 1 – Analyze
Step 2 – Strategize
Step 3 – Formalize
Step 4 – Implement
Step 5 – Monitor.
Pillar #3 - Prudence:

The third pillar builds upon Process (Pillar #2) to define the Dimensions, or the details, of a procedurally prudent investment process. A Dimension informs the fiduciary of the level of detail that should be incorporated in the fiduciary’s decision-making process. For example, the underlying Dimensions to Step 1 – Analyze are:

1.1: State goals and objectives (“objectives”)
1.2: Define roles and responsibilities of decision-makers
1.3: Brief decision-makers on objectives, standards, policies, and regulations.

Note that the Dimensions are simple straightforward statements, and that the language is universal—or “harmonized.” Ambiguous terms or language laden with regulatory or industry jargon are avoided.

Step 2 – Strategize (“RATE”)

2.1: Identify sources and levels of Risk
2.2: Identify Assets
2.3: Identify Time Horizons
2.4: Identify Expected Outcomes (“performance”)

Step 3 – Formalize

3.1: Define the strategy that is consistent with RATE
3.2: Ensure the strategy is consistent with implementation and monitoring constraints
3.3: Formalize the strategy in detail and communicate

Step 4 – Implement

4.1: Define the process for selecting key personnel to implement the strategy
4.2: Define the process for selecting tools, methodologies, and budgets to implement the strategy
4.3: Ensure that service agreements and contracts do not contain provisions that conflict with objectives

Step 5 – Monitor

5.1: Prepare periodic reports that compare performance with objectives
5.2: Prepare periodic reports that analyze costs, or ROI, with performance and objectives
5.3: Conduct periodic examinations for conflicts-of-interest and self-dealing, and breaches of a code of conduct
5.4: Prepare periodic qualitative reviews or performance reviews of decision-makers
Pillar #4 - Consistency:

An adviser should be able to apply a “harmonized” fiduciary standard across all client situations. Nothing trips up an adviser faster than inadvertently demonstrating through an audit or litigation that some of the adviser’s clients were treated differently than others. Most litigation and arbitration is the result of omission rather than commission. It’s not what the adviser did, but what the adviser forgot to do; and having a well-defined process can serve as an effective practice management checklist. Advisers can help to insulate their practice from liability by demonstrating that they have a procedurally prudent process that is consistently applied.

There also are economic justifications for consistency—back office efficiency. The adviser should define a procedurally prudent process, than focus technology on the fulfillment of that process. Advisers will not be able to deliver effective and efficient services if every other client who walks through the door is subject to a different process.

How Broker/Dealers Should Prepare for Coming Changes

Broker/dealers will be affected the most by the new regulations. However, contrary to the opinion of other industry observers, we do not believe every Registered Rep should be a fiduciary. Our rationale:

1. The fiduciary standard should apply only to the adviser (“Fiduciary Rep”) who accepts responsibility for the comprehensive and continuous management of a customer’s investments. The suitability standard is still the appropriate standard for a Registered Rep who is compensated for selling a product or executing a transaction (sell 100 shares of IBM).

2. The industry and investing public will be better served if there are product and transaction specialists who can continue to be licensed as Registered Reps. We need the specialist, whether it’s in muni bonds or insurance, who can present a Fiduciary Rep with their best products and services.

3. Not every Registered Rep has the experience and knowledge to serve as a fiduciary. A fiduciary engagement is, by definition, a consultative process which requires expertise and experience that surpasses the knowledge necessary to pass a securities exam.

4. A close corollary to the point #3, broker/dealers should limit which Registered Reps will be permitted to serve in a fiduciary capacity. Serving as a Fiduciary Rep should be a privilege earned, not a right given. The broker/dealer has the ultimate liability for the conduct of their Registered Rep, and we suspect the typical firm will be cautious as to who they register as a Fiduciary Rep.

Consistent with the above rationale, we believe broker/dealers can best navigate the coming changes by developing two parallel paths for their financial professional constituency: (1) Non-fiduciary Representatives; and (2) Fiduciary Representatives. How these two parallel paths are managed will have the greatest impact on the broker/dealer’s ability to prudently manage its own fiduciary liability.
We do not expect the major wirehouses to permit dual registration—the same Rep being permitted to serve in a non-fiduciary capacity in certain client situations, and as a fiduciary in other client engagements. This opinion is not driven by current fiduciary practices, but rather by operational necessity: Compliance departments, branch managers, and OSJs will find it difficult to properly supervise a universe of dually registered reps. Yes, we acknowledge that independent broker/dealers have navigated the challenges associated with dual registration, but the unique operations associated with the branch system of the major wirehouses make dual registration problematic.

Furthermore, forcing each Registered Rep to decide between being held to a fiduciary or a suitability standard may actually improve the Rep’s, and the broker/dealer’s, bottom line. When you examine the most successful Reps in the industry, the one constant is that they are focused—they are at the top of their game in whatever endeavor they pursue. Meanwhile, the least profitable Reps, and those that cause the biggest headaches to the home office, are those Reps who try to be all things to all clients.

Every broker/dealer should assess how well their organization is positioned to assimilate a fiduciary standard. Such an assessment should include a review of:

**Technology:** Broker/dealers should determine if all of the technology required by a Fiduciary Representative is already in place, or readily available. The specific tools that will be required include: (1) Asset allocation, or modeling software; (2) An investment policy statement generator; and (3) Screening tools so that investment options can be assessed during the implementation and monitoring phases of the investment process. Current client custodial statements will likely only require minor changes to make them fiduciary compliant, while client data-gathering checklists and risk questionnaires should already meet fiduciary standards.

**Policies and Procedures:** One of the reasons we anticipate difficulty with dual registration is that it is extremely difficult for the average person to be knowledgeable and up-to-date, and to recognize the differences between two different sets of policies and procedures. A procedures manual for a Fiduciary Representative is going to look quite different than the manual for a Non-fiduciary Representative.

**Training:** The traditional model for the training of new recruits will need to be amended to accommodate a fiduciary track. A consultative process is a requisite to a fiduciary standard, and such a process requires extensive education and experience. Broker/dealers will likely need to establish “time-in-service” requirements, such as five years, before a Registered Rep will even be considered eligible to apply for Fiduciary Representative status.

**Revenue Streams:** Pricing and compensation models will need to be retooled for Fiduciary Representatives. Even in the unlikely event that a fiduciary standard is not imposed, the elimination of 12b-1 fees, new requirements on how retirement advisers disclose their fees and expenses, and changes in advice provisions to IRA-rollovers will all have a material impact on traditional compensation models.
**Fiduciary Supervision:** Compliance personnel, branch managers, and OSJs will all need to be trained in fiduciary standards. These personnel will have the most impact on insulating the broker/dealer from potential fiduciary liability.

**The Marketing of Process and Product:** Of all the changes that will need to be made, the most difficult for most broker/dealers will be the addition of a “process” orientation to the organization’s existing “product” culture. Consistent with this change in orientation, marketing materials will have to be revised, and the firm’s value proposition to clients will have to be rebranded.

In closing, we anticipate that a fiduciary standard for Registered Reps is going to generate a lot of heat. The temptation will be to try to maintain the status quo; to disguise a suitability standard with more rules and disclosures, and try to pass it off as a “harmonized” fiduciary standard. We believe that these additional rules and regulations will add administrative and regulatory costs, but will not appreciatively improve the quality or objectivity of investment advice.

The primary reason that the Foundation felt it was important to publicize the new 2010 Fiduciary Standard is to provide an initial reference point for a “harmonized” fiduciary standard—to demonstrate to the industry that a fiduciary standard does not need to be a cumbersome and unwieldy set of rules and regulations and, when properly crafted, can significantly improve the prudent management of investment decisions.

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**About the Foundation for Fiduciary Studies**

The Foundation for Fiduciary Studies is a not-for-profit [501(c)(3)] organization established in September, 2000 to develop and advance registered standards for investment fiduciaries, which includes trustees, investment committee members, brokers, bankers, investment advisers, and money managers. The registered standards are designed to provide the details of a procedurally prudent process based on existing fiduciary legislation, regulations, regulatory opinion letters and bulletins, and case law.

The Foundation is independent of any ties to the investment community, and therefore positioned to be a crucible for advancing registered fiduciary standards throughout the industry and to the public. It maintains and updates the standards and practices as changes occur in legislation, regulation, and industry practices.
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