



Adams Hall

Asset Management

The Importance of the Fiduciary Standard

The recent financial crisis, marked by scandals including a \$50 billion Ponzi scheme orchestrated by Bernie Madoff and Allen Stanford's \$8 billion fraud, was caused largely by mismanagement and professional misconduct in the financial services sector. While the public, furious over their enormous financial losses, feels justified in directing their anger toward professionals in the financial industry, it is time to take a proactive stance to prevent another financial meltdown. The best way the public can do this is by educating themselves about the financial sector.

Most investors do not understand the difference between a stockbroker and an investment advisor. In fact, according to a recent study by TD AMERITRADE Institutional, "54% of investors believe that stockbrokers and investment advisors are required to act in the investor's best interest, 47% believe that stockbrokers are required to disclose all conflicts of interest, and 43% are unaware that different levels of investor protection even exist."¹ However, there is a significant difference between stockbrokers and investment advisors. The most important difference is the standard of care they hold themselves to. Investment advisors hold themselves to a professional standard of care known as "fiduciary duty." The word "fiduciary" comes from the Latin word for 'trust', "fiducia." According to Lori Richards, the SEC's former director of

¹ TD AMERITRADE Institutional, "Investor Perception Study 2006." Advisor Education Kit, <http://www.tdainst.com/advisor/advisoreducationkit.html> (accessed June 1, 2009).

the Office of Compliance, Inspections, and Examinations, “an adviser as that trustworthy fiduciary has five major responsibilities when it comes to clients. They are: 1) to put clients’ interest first, 2) To act with utmost good faith, 3) To provide full and fair disclosure of all material facts, 4) Not to mislead clients, and 5) To expose all conflicts of interest to clients.... (The key here is) to disclose material conflicts of interest in a “full and a fair” manner and to ensure your clients understand any material conflicts of interest before taking action.”²

Furthermore, the Supreme Court ruled in 1963, in *SEC v. Capital Gains Research Bureau*, that “investment advisers could not completely perform their basic function—furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments—unless all conflicts of interest between the investment counsel and the client were removed.”³

The importance of elimination, or at the very least mitigation, of all conflicts of interest has been established in numerous studies. One study in particular, “Estimating Operational Risk for Hedge Funds: The ω -Score”, developed “a quantitative model called the ω -Score to measure hedge fund operational risk.” Operational risk can be defined as “the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.”⁴ Researchers claim, “Half of the failed hedge funds are due to operational risk.”⁵ The study discovered “a strong relationship between legal/ regulatory problems and various measures of internal and external conflicts of interest.” The study deduced that “Funds with more conflict of interest issues, concentrated ownership, and low leverage ratios tend to have higher past

² Richards, Lori. “Fiduciary Duty: Return to First Principles”, Eighth Annual Investment Adviser Compliance Summit, February 27, 2006, www.sec.gov/news/speech/spch022706lar.htm (accessed June 1, 2009).

³ *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

⁴ INTERNATIONAL ASSOCIATION OF FINANCIAL ENGINEERS, Report of the Operational Risk Committee: Evaluating Operational Risk Controls, CONCLUSIONS AND FINDINGS ON THE TOPIC OF: “How should firms determine the effectiveness of their operational risk controls?”, November 2001, www.iafe.org.

⁵ See “Understanding and Mitigating Operational Risk in Hedge Fund Investments”, a Capco White Paper, March, 2003.

operational risk, suggesting that such risks may also extend to future behavior.”⁶ Funds with higher operational risks have a higher probability of losses, and therefore it would be in the investor’s best interest to avoid such funds. The most effective way to avoid operational risks is to eliminate, not merely avoid, all conflicts of interest.

While the fiduciary standard is based largely on principles, the commercial standard of care stock brokers hold themselves to is based largely on specific rules. However, this standard is much lower and is known as a ‘suitability’ standard. Suitability does not require that the broker place the investor’s needs above his own, simply that the broker make investment decisions that are “suitable” for the investor. Thus, it can easily be inferred that a universal fiduciary standard of care would be in the best interest of investors.

In light of the recent financial crisis, many are pressuring the government to adopt a universal fiduciary standard of care that would apply equally to both brokers and investment advisors. While this may seem like a no-brainer, controversy has been swirling over this proposal for months. There are several reasons as to why a universal fiduciary standard of care is needed. First, it is in the best interest of the investors. This claim is clearly supported by the definition of fiduciary duty, explained by both Lori Richards and the United States Supreme Court. Second, the adoption of a universal fiduciary standard of care would go a long way toward repairing investor trust that recent scandals destroyed. Rebuilding this trust would benefit both investors, allowing them to make better investment decisions through RIAs or brokers following a fiduciary standard of care, and the financial services industry, drawing more investors to use financial services because the investors are confident that these financial advisors will act in their best interest. While the adoption of a universal fiduciary standard of

⁶ Brown, Stephen J., Goetzmann, William N., Liang, Bing and Schwarz, Christopher, Estimating Operational Risk for Hedge Funds: The ω -Score (May 2008). Yale ICF Working Paper No. 08-08. Available at SSRN: <http://ssrn.com/abstract=1086341>

care would certainly go a long way in mending the investor-advisor relationship, simply adopting a universal fiduciary standard of care will not single handedly eliminate corruption in the financial services industry.

The key to mitigating corruption in the financial services industry is enforcement of the rules and principles of the fiduciary standard, and prosecution of all firms and individuals not abiding by the fiduciary standard of care. The responsibility of enforcing the fiduciary standard of care should be bestowed upon a regulatory agency. The question of which agency would be most effective as an overseer has greatly contributed to the controversy surrounding the proposal of a universal fiduciary standard. Currently, the frontrunners for this regulatory position are the Financial Industry Regulatory Authority (FINRA) and the U.S. Securities and Exchange Commission (SEC).

FINRA is a self-regulatory organization (SRO), whose members include all securities brokers in the United States. FINRA writes and enforces rules governing the securities industry and enforces federal securities laws, has jurisdiction over all broker-dealers and registered representatives, and has the authority to discipline firms and individuals who violate the rules. The SEC is responsible for enforcing the federal securities laws and regulating the securities industry, the nation's stock and options exchanges, and other electronic securities markets. The SEC regulates RIAs if they have \$25 million or more in assets under management. A RIA with less than \$25 million in assets under management is regulated by the the securities department of its state.⁷

While many are calling for the implementation of a universal fiduciary standard of care, the Securities Industry and Financial Markets Association, SIFMA, is calling for a 'universal

⁷ Aschkenasy, Janet. "Will FINRA Police Advisors Going Forward." Financial Advisor Magazine 10 Apr. 2009. 2 June 2009 <<http://www.fa-mag.com/online-extras/4053-will-finra-police-advisors-going-forward.html>>.

standard of care'. Tim Ryan, president and chief executive of SIFMA, recommended to the Senate Banking Committee on March 10 "the adoption of a universal standard of care that avoids the use of labels that tends to confuse the investing public."⁸ This drew great criticism from both sides, as many believe abandoning the fiduciary duty and replacing it with a 'universal standard of care would lower the standard of care across the board.

Others, specifically the Financial Industry Regulatory Authority (FINRA), have suggested 'harmonizing' the suitability standards of brokers and the fiduciary standard of investment advisors. FINRA chief Richard Ketchum reasons that "suitability provides a level of specificity and value over and above a fiduciary standard," noting that enforcement cases are easier to bring based on suitability.⁹ However, contrary to Mr. Ketchum's comments, if a universal fiduciary standard were implemented, its principles would encompass all suitability laws and regulations. It would not be any more difficult to bring enforcement cases if there was a fiduciary standard because if someone were not following fiduciary principles, they would not be following suitability regulations. Neil Simon, vice president of government relations for the Investment Adviser Association in Washington argues "Fiduciary is the highest standard recognized under the law. There is far less evidence of investor abuse with the fiduciary standard."¹⁰ Not only has FINRA suggested 'harmonizing' suitability and fiduciary standards, but there is also a widely held belief that FINRA is pushing to become the regulatory agency that enforces the new standard. According to Mercer Bullard, president and founder of Fund

⁸ Hansard, Sara. "SIFMA: Replace 'fiduciary duty' with 'universal standard of care'" Investment News 10 Mar. 2009. 1 June 2009 <<http://www.investmentnews.com/article/20090310/REG/903109958>>.

⁹ Hansard, Sara. "Finra boss calls for fiduciary standard for all advisers." Investment News 13 Mar. 2009. 3 June 2009 <<http://www.investmentnews.com/article/20090513/REG/905139971>>.

¹⁰ Hansard, Sara. "Finra walks fiduciary/suitability tightrope." Investment News 17 May 2009. 1 June 2009 <<http://www.investmentnews.com/article/20090517/REG/305179968>>.

Democracy Inc., “[SEC Chairman Mary] Schapiro and Ketchum think that bargaining away the fiduciary issue may result in FINRA becoming the adviser [regulator]”.¹¹

If FINRA were to become the regulator, it is widely believed that the proposed “fiduciary standard” would be lowered to minimize the jump brokers would have to make in their standard of care. At the base of this fear is the fact that FINRA is a self-regulatory organization (SRO). FINRA oversees securities brokers and “should not have any part of this board [regulatory authority], because it is an organization focused on its members [brokers] and operated for the benefit of its constituents”, according to Richard Salmen, President of the Financial Planning Association (FPA). Additionally, FINRA is ill suited to oversee a high fiduciary standard because it focuses on a suitability standard of care. Finally, if FINRA were to become the regulator, it would have to add investment advisors to its board, as it is not currently equipped to regulate investment advisors. The SEC, on the other hand, already regulates RIAs and ensures that they are following a fiduciary standard of care. Marilyn Capelli Dimitroff, chairperson of the Certified Financial Planner Board of Standards, criticizes FINRA’s record for using rulemaking authority as “mixed at best”; possibly referring to the decrease in enforcement actions by FINRA in 2008 compared to 2007.¹² Fines levied by FINRA decreased 55% from \$77.6 million in 2007 to \$35 million in 2008.¹³ This is of particular interest due to the recent plethora of financial scandals, which would cause one to reason that there should have been an increase in fines in 2008.

Currently, the best option for the regulator position appears to be the SEC. It has already

¹¹ Hansard, Sara. "Fiduciary Standard an Issue in Unifying Advisory Regulations." Investment News 5 Apr. 2009. 1 June 2009 <<http://www.investmentnews.com/article/20090405/REG/304059979>>.

¹² Shidler, Lisa, and Jed Horowitz. "Planner, Adviser Coalition Seeks New Regulator, but not Finra." Investment News 28 Apr. 2009. 2 June 2009 <<http://www.investmentnews.com/article/20090428/REG/904289967>>.

¹³ Kelly, Bruce. "Finra Brought Fewer Enforcement Actions in '08; Fines Against Individuals Fell as Well." Investment News 3 June 2009. 4 June 2009 <<http://www.investmentnews.com/article/20090603/REG/906039990>>.

been shown that FINRA would not be appropriate for a regulatory position, and any other SRO would face serious conflicts of interest. Not only is the SEC independent, but it also has vast resources with which it could regulate the industry. The SEC is experienced in regulating fiduciary standards because it currently regulates all registered investment advisors with total assets over \$25 million, ensuring that they live up to the fiduciary standard of care.

Legislation enacting a universal fiduciary standard of care is likely to take quite a bit of time, as Congress considers other financial issues a higher priority. In the mean time, individuals can protect their investments through many avenues. One such avenue of protection is researching potential brokers or investment advisors. There are several things to look for when researching a potential broker. For starters, check to see if a broker is registered or licensed. This is very important because if one does business with an unregistered securities broker and that firm later goes out of business, there may be no way to recover one's money, even if an arbitrator rules in the investor's favor. In addition to checking the registration status of a potential broker, one should research the employment qualifications and disciplinary histories of each potential broker. This information is free and easily accessible at www.finra.org/brokercheck. However, it may be wise to check with one's state securities regulator first, as they may be able to provide more information from the Central Registration Depository (CRD) than FINRA, especially regarding investor complaints. Contact information for each state's securities regulator can be found at www.nasaa.org.¹⁴ After thoroughly researching a potential broker, personally ask the broker about the kinds of incentives he or she may receive. Mercer Bullard, an assistant professor of law at the University of Mississippi School of Law, says investors should ask "for a list of all compensation received in connection

¹⁴ "Check Out Brokers and Investment Advisers." U.S. Securities and Exchange Commission (Home Page). 4 June 2009 <<http://www.sec.gov/investor/brokers.htm>>.

with any transactions, and get an answer in writing...Under law, they cannot misrepresent that, so you will be legally protected if you have that in writing".¹⁵

When researching a potential investment advisor, request a disclosure document known as the "Form ADV Part 2," which all RIAs are required by law to provide. Thoroughly read Part 1 and Part 2 of the "Form ADV." Part 1 contains information about possible problems advisors may have had with regulators or clients in the past, as well as details about the advisor's business. Part 2 outlines the advisor's services, fees, and investment strategies. An RIA's most recent Form ADV, Part 1 only, can be freely accessed online at www.adviserinfo.sec.gov. To obtain the Form ADV Part 2, simply ask the RIA directly, as the law requires they provide it.

Investors' confusion regarding the difference between RIAs and brokers stems from the fact that many brokers refer to themselves as "financial advisors" or "wealth managers." Do not be fooled by this deceptive use of words, as only RIAs hold themselves to a fiduciary standard of care. As previously illustrated, conflicts of interest significantly affect portfolio performance, and following a fiduciary standard remains the best way to avoid conflicts of interest. Ultimately, the decision to use either an RIA or a broker is an individual's decision. Nevertheless, knowledge is power, and full understanding of the difference between RIAs and brokers is vital if an investor is to choose the best professional to manage their assets.

¹⁵ Levitz, Jennifer. "Taking Control." *The Wall Street Journal* 1 June 2009. 1 June 2009
<<http://online.wsj.com/article/SB10001424052970203334304574159580260805044.html>>.