The Fiduciary Difference:

What Consumers Should Know

A Special Report by

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FINANCIAL GUIDANCE

Group, Inc.

The Fiduciary Difference: What Consumers Should Know

"I think the time has come to erase the distinction in regulatory standards, and bind Brokers and Registered Investment Advisors by precisely the same fiduciary standards. When you go into a doctor's office, you know they are placing your health first and foremost, and you should feel precisely the same way about your Investment Advisor and Broker."

~ Arthur Levitt, former Chairman of the Securities and Exchange Commission, October 2006.

Executive Summary

Many types of professionals provide financial advice to individuals and families. These professionals might call themselves stockbrokers, financial advisors, insurance agents, trust company officers, or many other titles.

While each type of financial professional promises to do his or her best for a client, there are substantial differences in how they operate. The most important difference is where an advisor's fiduciary duty is placed. A fiduciary standard defines where an advisor's ethical and legal responsibility lies; ultimately, who is he or she responsible for protecting.

Registered Investment Advisors have a fiduciary duty to their clients first and foremost; "investment brokers" and "registered reps" have a fiduciary duty to their employers. The difference is immense; Registered Investment Advisors are required, legally and ethically, to place their clients' interests first. Brokers are required to place their employer's interests above their clients'. In other words, brokers can give advice to clients that can be more costly and less effective, without violating their legal obligations.

In the past few years, the issue of fiduciary duty has gained prominence. The scandals in the mutual funds industry, student loan industry, and brokerage industry all highlighted the difficulty that consumers face in finding investment advisors who work in their best interests.

A recent court ruling might finally tip the balance in favor of the investing public. On March 30, 2007, the Washington, D.C., District Court of Appeals voided the long-standing exemption that allowed brokers to call themselves "financial advisors." The ruling will require that brokers

either adopt a true fiduciary role, or explain much more clearly to their clients how much they are being paid, and by whom.

The new rules have yet to be written to define how brokers will have to disclose their conflicts of interest, forms of compensation, and lack of fiduciary responsibility towards clients. But the lawsuit's outcome has started in motion a process that will surely lead to better information and greater protection for consumers.

The message of the District Court can be summed up as: Registered Investment Advisors have a fiduciary responsibility to their client. Investment brokers have a fiduciary duty to their employer. It makes a world of difference.

The Fiduciary Difference

In today's complex economic environment, many individuals and families turn to experts for advice on financial matters. These experts have a wide range of skills, training, and backgrounds. Accountants, stockbrokers, trust company officers, independent financial advisors—each of these professionals, and many others, offer financial advice and guidance.

Selecting the right type of advisor from among these choices is difficult. Today, it is harder than ever because these many professionals are offering similar services. An accountant might advise a client about how to get a good rate on a mortgage or home equity loan. An insurance broker might offer advice about how to invest in a whole life insurance policy. A financial advisor might suggest long-term care insurance. And so on.

Tangible Factors. Selecting a financial advisor involves weighing many factors, both tangible and intangible. The advisor's training and experience are important. Cost is a consideration. The types of services the advisor can provide also are very significant. These factors are tangible and fairly easy to identify.

Intangible Factors. For many people, the intangibles are just as important. Surveys have found that the investing public says that trust in an advisor is often the single most important factor in making a decision. But how does anyone know whom to trust?

References from friends, relatives, and colleagues are a source of information. Lists of the "best" advisors, compiled by magazines, newspapers, and Websites, might give some sense of an advisor's reputation. Also, meeting an advisor and his or her staff sometimes provides signals about reliability.

There is another excellent way to assess the trustworthiness of an advisor: the fiduciary standard. The National Association of Personal Financial Advisors defines a fiduciary advisor this way:

> *A financial advisor held to a fiduciary standard occupies a position of special trust and confidence when working with a client. As a fiduciary, the financial advisor is required to act with undivided loyalty to the client. This includes disclosure of how the financial advisor is to be compensated and any corresponding conflicts of interest.*

Consumer advocates and financial advice columnists regularly recommend that investors work with fiduciary advisors.

> *"Can you trust your financial advisor? Knowing your planner's exact job title may help you tell whether he or she is a 'fiduciary' — a professional who's 100% committed to putting your financial interests first."* ~ CNN columnist Liz Pulliam Weston.

The fiduciary standard is a powerful commitment. The Retirement Corp. of America has estimated that more than 650,000 people provide some form of direct financial services in the U.S. today. Yet, fewer than 10% of the people who call themselves financial advisors today are legally required to act as fiduciaries. In other words, more than 90% of "financial advisors" do not have to give advice that is in the client's best interest.

How can a consumer tell if an advisor is a fiduciary? Why does it matter? Why did the current system evolve? How will the system be fixed? We will now explore these questions.

Fiduciaries, the Merrill Lynch Rule, and Consumer Confusion

Different types of financial advisors have very different loyalties, known in legal terms as "fiduciary responsibility." Registered Investment Advisors have a fiduciary responsibility to their clients, but investment brokers or registered reps have a fiduciary responsibility to their employers. The Securities and Exchange Commission (SEC) ratified this difference through interpretive rulings about the 1940 Investment Advisors Act, which governs how different types of advisors are regulated and overseen.

The SEC made it explicit that Registered Investment Advisors (RIA's) must work in the fiduciary interest of their clients. In other words, they must put their clients' interests ahead of their own when giving financial advice. This is the highest level of consumer protection. A survey by the National Association of Personal Financial Advisors in 2007 found that 97% of consumers say they would seek counsel from an advisor who is adhering to this type of fiduciary standard.

The fiduciary requirements for RIA's are very powerful. Among the activities that are prohibited are:

- Acting as an issuer or affiliate of an issuer of securities.
- Recommending unregistered, non-exempt securities or the use of unlicensed broker-dealers.
- Charging unreasonable fees.
- Failing to disclose to all customers the availability of fee discounts.
- Using contracts which seek to limit or avoid an adviser's liability under the law.
- Limiting a client's options with regard to the pursuit of a civil case or arbitration.
- Borrowing money from or lending money to clients.

(Source: www.seclaw.com)

However, the SEC declared that brokers do not incur the same fiduciary duty as RIA's. For several decades, brokers have been granted a special exemption that allowed them to place the financial interests of their employers above those of their clients. This exemption is known as the Merrill Lynch Rule, named after the company that originally requested the exemption. The exemption was based on the notion that brokers were not providing financial advice, but merely helping clients engage in a financial transaction, such as buying or selling a stock. The client was presumed to have a good understanding of what he was doing, as well as the fact that the broker was not working on his behalf.

For a long time, this dual regulatory system worked. A person who wanted extensive, fiduciary financial advice would go to an RIA, and a person who basically wanted to conduct a transaction would go to a broker.

However, with the rise of the discount brokerage companies, the business of handling stock and bond transactions became much less profitable — essentially a break-even business. Brokerage firms needed to expand their lines of business. So they used the protection of the Merrill Lynch Rule to start calling their sales representatives "financial advisors" or "financial consultants." Brokerages were implying that they were providing services similar to Registered Investment Advisors.

The new terminology blurred the extraordinary differences in how customers were treated by brokers, as compared to RIA's. Imagine two people who are seeking advice from two different financial professionals. One professional is an RIA, and one is a broker. The RIA is required by law to act in the client's best interests at all times; the other is required to act in his employer's best interest, even if it is in conflict with the client. Who is likely to suggest an investment with a high commission? Who is likely to suggest an investment that is being marketed by his company? Who is likely to suggest shifting money from one investment to another, when the shifting generates a commission?

Wall Street firms continue to argue today that consumers understand the motivations of brokers. Consumer advocates argue that consumers do not understand where brokers' loyalties lie. Consumer advocates say that brokers should not be marketed as "financial advisors" or "financial counselors." These job titles wrongly imply to consumers that brokers are providing independent financial advice.

Numerous studies confirm the claims by consumer advocates. One key study was performed in 2004 on behalf of TD Waterhouse, now known as TDAmeriTrade. Among the study's conclusions:

- 58% of investors incorrectly believed that both stockbrokers and advisors had a fiduciary responsibility to act in the investor's best interests.
- 63% incorrectly believed that both stockbrokers and investment advisors were required to disclose all conflicts of interest prior to providing financial advice.
- Nearly 85% of investors expected all financial professionals offering fee-based financial advice to provide these protections.

A study by the Consumer Federation of America, also in 2004, found that investors are troubled by the different standards of different advisors. The Federation found that 91% of investors said

that brokers who offer investment advisory services should be subject to the same investor protection rules as all other investment advisers.

The blurring of the lines between different types of advisors has troubled many consumer advocates. Here's what Barbara Roper, Director of Investor Protection for the Consumer Federation of America, said in December 2004:

> *Today, financial professionals who are indistinguishable to the typical investor are subject to two very different standards of conduct. No one in their right mind would intentionally set out to create such a marketplace, but that is exactly what the SEC has done by continuing to rely on method of compensation to draw the line between brokers and advisers long after it had long ceased to perform that function effectively*

This difference is compounded if the broker who is protecting his company's interests is being paid a commission or bonus based on what he convinces a client to purchase. The broker has a tremendous incentive to recommend the purchase of a particular financial product. But he does not have a legal requirement to explain his motivations to his client.

Fiduciary Standard vs. Suitability Standard

To be fair, brokers are covered by regulations that govern how they must treat their clients. Interpreting the Investment Advisors Act, the SEC allowed brokers firms to use the Merrill Lynch Rule only if: (1) their advice is solely incidental to their brokerage activities (which is selling investments and clearing stock and bond transactions); and (2) they are not receiving special compensation for their advice (meaning advisory fees).

However, "solely incidental" was expanded over the years to include almost any type of advice that an advisor could offer. The "solely incidental" restriction became meaningless, and brokers could basically provide any service without having to act in the best interest of their clients.

The exemption allowed brokers to avoid being held to the fiduciary standard. Instead, brokers were bound by a "suitability standard," which is defined as: (1) knowing a client's financial situation well enough to understand his or her financial needs; and 2) recommending investments that are suitable based on that knowledge. The suitability standard does not require the complete, up-front disclosure of compensation and conflicts of interest to which Registered Investment Advisors are held.

For the past decade, RIA's protested that brokers have abused the Merrill Lynch Rule loophole. Instead of evolving towards becoming true fiduciaries, brokerage firms were charging fees *and continuing to sell in-house products with commissions*. They were trying to have the best of both worlds: the trust of a fiduciary, but the freedom to make profitable or conflicted recommendations

The conflict between what brokers were doing and what they were supposed to be doing potentially harmed tens of millions of investors.

As the Investment Counsel Association of America (now known as the Investment Advisor Association) pointed out in a 2005 comment letter to the SEC:

> *…portfolio management, selection of portfolio managers, and asset allocation services, even where performed on a non-discretionary basis, should not be considered to be solely incidental to brokerage transactions. Such services are core investment advisory services that should be subject to the fiduciary protections of the Advisers Act. These services have a "quintessentially supervisory or managerial character" that the Commission recognizes "as a critical indicator of services that warrant the protection of the Advisers Act because of the 'special trust and confidence inherent' in such relationships."*

Arthur Levitt, the longest-serving chair of the Securities and Exchange Commission, described the impact of the Merrill Lynch Rule in these scathing terms at a conference in October 2006:

> *The so-called Merrill Lynch Rule that exempts brokers from the fiduciary requirements of the Investment Act of 1940 only confuses investors. While brokers will counter that that they are under NASD [National Association of Securities Dealers] oversight, they are simply not regulated with the consumers' interest in mind. They are not required to obtain best execution pricing for trades and are allowed to sell to a client more expensive investment vehicles that will generate greater commissions to the broker.*

Levitt next offered his prescription for solving the problem:

> *There is absolutely no reason why a fiduciary responsibility imposed upon investment advisors should not apply to retail brokers with equal coverage. The notion that a retail broker is an order taker is an absolute and total fiction.*

Lawsuit Strikes Down Merrill Lynch Rule

When the SEC began to revise and update the Investment Advisors Act in 1999, many financial services organizations and consumer groups encouraged the Commission to equalize the fiduciary requirements for all professionals who called themselves financial advisors. During the rulemaking process, the SEC proposed substantial revisions and tighter definitions for "solely incidental" financial advice. But in the eyes of many in the industry, the Commission did not go far enough.

Dissatisfied with the rulemaking proposal, the Financial Planning Association (FPA) sued the SEC. The FPA argued that it is not fair to consumers for individual brokers to be exempt from registering with the SEC or state regulators as Registered Investment Advisors. Brokers should meet fiduciary standards set by the SEC and state regulators if they are providing financial planning and investment-related advice. (It should be noted that investment advisors who manage more than $30 million must register with the SEC, whereas advisors who manage less than $25 million must register with the regulatory body in each state in which they operate; those in the middle can choose either option.) On March 30, 2007, the U.S. Appeals Court for the District of Columbia ruled in favor of the FPA and said that the Merrill Lynch Rule could not stand.

The SEC announced on May 14, 2007, that it would not appeal the court's opinion.

Now that the legal arm wresting is over, the situation in the marketplace will change. Governing bodies that regulate investment brokers are writing rules that define how brokerage firms and their registered representatives (company-compensated sales people) must comply with the new rules. It is likely that brokers will have to disclose more clearly to clients how they are compensated and where their financial loyalties are placed. The fiduciary difference will become a bright line again.

The basic distinctions between Registered Investment Advisors and brokers will remain. Brokers still will have a fiduciary duty to their employers, and they still will have financial incentives to favor one investment recommendation over another. The difference is that consumers will have more information before they decide to work with a broker or an RIA.

Q&A on Practical Differences between Brokers and Fiduciary Advisors

The following Q&A section outlines the practical differences between brokers and fiduciary advisors, and how they affect a typical investor.

1. **What is the difference between how brokers and fiduciary Registered Investment Advisors are regulated?**

The public is protected in two very different ways from any malfeasance by these professionals. Brokers must submit to what is called "compliance," which basically means they have to "comply" with the rules governing their sales activities. For instance, that means if they recommend a mutual fund that is owned and operated by their firm, and which pays them an extra commission, they have to make sure that this is disclosed somewhere in the fine print of the many documents they give to the customer.

Brokers argue that the compliance rules are so strict and exacting that consumer protection is quite strong. This argument is seriously weakened by the many individual brokers who have been the subject of complaints by clients in the past few years. The NASD, which writes and enforces the rules for brokers, has recorded 36,379 different arbitration claims against brokers and their firms over the five years ending December 31, 2006.

It should be added that investors must sign an arbitration agreement to work with a broker. This means that investors give up their rights to sue in the event of a dispute. Instead, investors take their complaint to a panel of arbitrators (who are paid by the brokerage industry). Needless to say, winning restitution in a complaint is difficult.

By comparison, Registered Investment Advisors are held to a fiduciary standard. They have to put the clients' interests ahead of their own or of the company they work for. It is very unlikely that an RIA would recommend an investment product that pays an extra commission. When a dispute arises, a consumer can contact the SEC or a state regulator (depending on where the RIA

is registered), and a formal inquiry can be launched by government attorneys and investigators. A consumer also can sue.

A study by the SEC concluded: "The most common type of securities professionals against whom the SEC brought actions were individuals associated with broker-dealers such as registered representatives and branch managers. The most common types of cases involved securities offerings and fraud against broker-dealer customers."

2. **I understand that some brokers don't have my interests at heart. But I trust my broker; he works for a very reputable company, and he is selling good investments.**

The lack of fiduciary commitment to consumers warps the practices of Wall Street brokerage firms. A focus on their own financial interests led these firms in the dot-com boom period to recommend Initial Public Offerings (IPO's) for companies that were not financially sound. The firms' brokers promoted those stocks to clients aggressively, even as they plummeted in value.

While the excesses of the dot-com period have passed, these same brokerage firms continue to promote expensive investments to consumers. One primary example is that brokerage firms, as well as insurance companies with which they have financial ties, sell high-commission variable annuities and life insurance contracts as retirement plans.

These conflicts-of-interest have damaged investors for decades. Arthur Levitt, former chairman of the SEC, said this about his experiences on Wall Street in the 1960s and 1970s:

> *"The conflicts of interest I saw in the securities business were unbelievable. Everywhere we turned, there were conflicts, ranging from what our analysts said about companies that we hoped to underwrite, ranging from the outrageous commissions being paid for secondary and IPO's, ranging from who got which hot issue, and who did not. On and on and on."*
>
> (Arthur Levitt speech to National Association of Personal Financial Advisors conference, October 2006)

The message is: Beware of brokers. Nationally syndicated financial advice columnist and author Jane Bryant Quinn put it succinctly in her latest book, *Smart and Simple Financial Strategies for Busy People:*

> *"You don't need 99.9 percent of what Wall Street is selling. It's expensive, unsuitable or stupid. Most investments are designed to profit the brokers, banks and insurance companies, not you."*

3. **Why are brokerage firms fighting so hard against having to act as fiduciaries?**

Brokerage firms are fighting against the fiduciary standard because their entire business model is based on doing what is in their interests, rather than what is in the interests of their customers. Every expensive in-house fund recommendation, every IPO recommendation, every piece of advice regarding insurance or stocks would have to primarily benefit the customer, not the broker or the brokerage company's bottom line.

Here are some of the ways that a brokerage firm makes money today. Each of these would be under siege if the firm were held to a fiduciary standard:

- The company manages its own in-house mutual funds, which charge above-average fees. One of the jobs of a broker is to recommend mutual funds to his or her customers. Guess which ones often come highly recommended?
- The company sells IPO shares to the public, and the company's brokers recommend that their customers buy IPO shares. How many brokers tell their clients that their firm is managing the IPO, or show them data that few IPO's are good investments?
- The company has its own life insurance subsidiary, and the company's brokers recommend that their customers buy life insurance coverage. Do the clients know that the broker earns a bonus if insurance is purchased?
- The company owns stocks in its own investment account. The company's brokers recommend those stocks to their customers. Is it possible that the brokers are told to recommend stocks that the company wants or needs to dump because the analysts have discovered a problem with the company's earnings?

If brokerage firms were held to a fiduciary standard, all of these recommendations would be examined in light of whether they really were best for the customer. Brokers would be forced to recommend the better (often no-load) investments, and the company's weak in-house products would languish

Furthermore, these companies would be required by the SEC to fully disclose the potential conflicts of interest in each recommendation. The disclosures would have to be made in plain English. That's why brokerage firms are fighting against a fiduciary standard.

4. **Is there a solution that would allow the brokerage firms to survive, but still offer adequate protection to the public?**

In advertisements and in sales pitches, brokerage firms slyly position themselves as financial advisory firms. Their goal is to seem as if they are providing independent advice. This is a very different process than the traditional (and legally defined) role of selling investments and insurance to customers who are fully aware that they are involved in a sales process

One uncomplicated solution would be to have brokerage firms publicly acknowledge that their brokers serve in a sales capacity. There is nothing wrong with brokers being salespeople. We rely on salespeople all the time, such as when purchasing a car. The difference is that we know what the person selling us the car is trying to do, and we have a fairly good idea that he or she is going to be paid only after we buy a car. Brokers should disclose in the same way, and make it clear that they are selling a product. Then consumers would understand that a broker has no more incentive to sell a low-cost mutual fund than a person working at a Ford dealership would have to tell you that the Toyotas down the street are better cars for the price.

The solution is to make brokers stop pretending to be something they're not. It really is that simple.

5. **Is there an easy way for a consumer to know whether a "financial advisor" is held to a fiduciary standard or not?**

The easiest thing to do is ask the advisor if he or she is a Registered Investment Advisor. This could be an SEC or a state-level registration. Also, ask if this person is willing to be held to a fiduciary standard in his or her recommendations, and whether he or she would be willing to put that in writing.

All Registered Investment Advisors will gladly provide a prospective client with a copy of Form ADV Part II. This extensive disclosure document explains in great detail the advisor's credentials, experience, training, possible conflicts of interest, form of compensation, and more. The Form ADV Part II is updated annually and filed with either the SEC or the state, depending on whether the advisor manages over $25 million or more for his or her clients.

Another indicator of an advisor's fiduciary commitment is membership in the National Association of Personal Financial Advisors (NAPFA). All NAPFA-Registered Advisors offer comprehensive financial planning services on a Fee-Only (commission-free basis) and are held to a strict fiduciary standard. NAPFA has developed an extensive Fiduciary Questionnaire, and excerpts from that questionnaire are available on below.

Investors seeking a fiduciary advisor also should look for credentials such as "AIF" after an advisor's name. AIF® stands for "Accredited Investment Fiduciary," and this designation is conferred by the Center for Fiduciary Studies.

Be careful when asking if an advisor is a Registered Investment Advisor. If the advisor says that "a division of the company is registered," then he or she is probably not held to the fiduciary standard. Instead, this advisor is likely to be a broker who works for a large firm that has registered. Thus, the broker is bound to serve his or her employer, not his or her clients. This "advisor" can recommend awful investment products, as long as the correct paperwork is filed.

6. **Why should investors voluntarily settle for anything less than full disclosure and advice that is designed to benefit them?**

Why indeed?

Questions to Ask Your Financial Advisor

- Do you have a legal obligation to act in my best interests?
- How are you and your firm compensated?
    - Fee-Only
    - Fee-Based
    - Fee-Offset
    - Commissions

- Does any member of your firm act as a general partner, participate in, or receive compensation from investments you may recommend to me?
- Do you receive ongoing income from any of the mutual funds that you recommend in the form of 12(b)1 fees, trailing commissions, or other payouts?
- May I have in advance of signing an agreement to work with you a specific description, in writing, of your fees and the services you will provide?

Adapted from the FocusOnFiduciary™ information developed by the National Association of Personal Financial Advisors (NAPFA). Used with permission. Visit www.focusonfiduciary.com for more information.

About Financial Guidance Group

Carl von dem Bussche, CFP®, AIF® a native of Tampa Bay, founded Financial Guidance Group in 1993 to provide independent, objective financial planning services. He was one of the first fee-only planners in the Tampa area and remains one of the few planners who provide comprehensive planning that includes client goals, taxes, cash flow, insurance, estate planning, retirement planning and investments. A staunch advocate of the fee-only planning model (which means no commissions or third-party compensation is ever accepted), he believes there is an inherent conflict of interest when planners stand to gain financially from the financial solutions they recommend.

Other financial professionals rely on Carl's knowledge and experience. He has served both as an expert witness on financial matters and has served as an industry arbitrator for the National Association of Securities Dealers (NASD). Carl also completed the process of becoming a CERTIFIED FINANCIAL PLANNER™ professional through the College for Financial Planning in Denver, CO. Planners like Carl who have successfully completed all the requirements set forth by the Certified Financial Planner Board of Standards, Inc. are generally recognized as the most qualified financial planners in the country. Carl has earned the AIF® credential – which stands for "Accredited Investment Fiduciary™ " – from the Center for Fiduciary Studies. He has also earned a 5-Star rating from the Paladin Registry, an independent screening organization and consumer watchdog.

Carl is a member of the National Association of Personal Financial Advisors (NAPFA), the nation's premier organization for fee-only comprehensive financial advisors. He has qualified as a NAPFA Registered Financial Advisor™NAPFA members are required to earn double the continuing education credits (CE) than required by the CFP Board of Standards. This is 30 hours annually. Carl has also served as a member of NAPFA's South Region Board of Directors and facilitates various educational workshops. Visit www.financialguidancegroup.com for more information about Carl von dem Bussche and his firm and access a special questionnaire you can use to determine if the advisor you're considering is held to a fiduciary standard.

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