

But Aren't All Investment Advisors Fiduciaries?

From time to time, we are asked about differences in standards of practice among various types of investment practitioners. Registered Investment Advisors [RIAs] that meet a threshold of assets under management are regulated by the SEC under the Investment Advisors Act of 1940 (smaller RIAs are regulated by state securities regulators). Generally, the 1940 Act provides that the Advisor must act as a fiduciary which, according to the SEC, means that the Advisor must seek to avoid conflicts of interest with his or her clients, and to disclose to them such conflicts of interest as may then remain. It is a short—but *unwarranted*—leap of logic to assume that any person offering investment advisory services to a client will, in fact, provide conflict-free services, at a level of care skill and caution demanded from a fiduciary. In fact, it is in the first place almost impossible to eliminate every conceivable conflict of interest, and in the second place quite a few advisory firms don't try very hard to do so. This is sometimes surprising to trustees who have assumed that designations such as "registered investment advisor" or "independent registered investment advisor" are synonymous with a strict adherence to fiduciary principles. Trustees should look beyond the RIA designation to determine the extent to which their advisor is acting in a fiduciary capacity.

A portion of the national Trust & Estate bar periodically decries the propensity by some investment advisors to use their advisory agreements to avoid requirements that would otherwise be imposed upon them by fiduciary standards. "Opportunistic behaviors" in the fiduciary accounts of banks, brokerage firms, and other institutions are often disclosed in investment advisory agreements drafted by their legal departments. If, as a condition of receiving investment advice, such an agreement is reviewed and signed by trustees, some legal commentators suggest that the parties have agreed not to apply certain provisions of the default standards of prudent asset management embodied in state prudent investor statutes or other relevant law. Trustees asked to sign such agreements should be fully aware of the consequences of substituting contractual provisions, defined by a document drafted by corporate legal counsel, for the default rules of their state prudent investor statutes.

Sometimes it requires a high degree of financial sophistication even to realize that an agreement gives an investment firm a hunting license to make money at the expense of the trust. We will offer a case example later in this discussion. For now, consider the simple provision that the investment firm has the discretion to determine the trade venue for presentation of security buy/sell orders, and that the firm will assure that all orders obtain, at least, the nationally posted best-bid-and-offer [NBBO] price. This seems to be a reasonable provision because the investment firm has trading expertise. Furthermore, it appears to be a valuable consumer protection lest security transactions occur at unfavorable prices. In reality, however, the provision gives the investment firm license to ignore trade venues which offer higher probabilities for price improvement—bid and offer prices better than posted NBBO. Such a provision enables the firm to participate more readily in payment-for-order-flow arrangements or other types of "soft dollar" compensation programs, to internalize orders while collecting the full bid/ask spread on both sides of the transaction simply by matching orders in their customer book, or to act as a

potentially adverse counterparty to the trust in a principal trade (rather than as an agent for the trust by trading in a public market or alternative liquidity venue).

Disclosure of conflicts of interest rather than avoidance of conflicts of interest is a commonly used technique to water down—or, some would argue, to gut—reasonable standards of fiduciary practice. For trustees and legal counsel, this puts a premium on the ability to read and fully comprehend the implications of the investment advisory agreement that an investment advisor presents to them. For larger trusts, foundations and endowments, it also puts a premium on the skill sets required to draft truly informative RFPs when seeking to acquire or retain advisory services. In a legal evolutionary dance, the stricter disclosure requirements of recent statutes increase the volume of disclosure materials that trustees must evaluate, and prompt marketing departments to find ever more creative ways to disclose conflicts of interest disclosures as if they were beneficial to the client. Interestingly, it is often the Department of Labor’s oversight activity for retirement plans that stops the music and puts a halt to some of the more egregious practices. But the DOL has jurisdiction only over certain tax-qualified trusts.

A common business model for RIA firms is the “hybrid practice model.” This term refers to firms that are dually registered as both an investment advisory firm regulated under the 1940 Act and as a registered representative of a broker-dealer under the Securities and Exchange Act of 1934. Representatives of dually registered firms sell Investment Advisory Services as fiduciaries, and sell securities as registered representatives of a stock brokerage firm. The 1940 Act demands a fiduciary standard of care—unless the advisory firm contracts out of it through client execution of an investment advisory agreement indicating client acceptance of certain disclosed practices. By contrast, the 1934 Act demands a lesser “suitability” standard of care.

Needless to say, the terminology becomes very confusing. A trustee must distinguish among services offered by an independent RIA, an Independent Broker-Dealer, a Corporate RIA, a Registered Representative, a Registered Investment Advisor, and an Independent Investment Counsel. Some of these designations imply a fiduciary standard of care, others a lesser standard of care. The same individual may switch hats in the middle of an engagement in order to provide “full service” to the trust. For example, asset allocation modeling might be done under the auspices of a Corporate RIA structure while portfolio implementation might occur under standards applicable to registered representatives. Registered representatives are typically affiliated with broker/dealers that are regulated by FINRA (the Financial Industry Regulatory Authority, a self-regulatory organization controlled and funded by the firms it regulates). While brokers are required to provide their services in a fair and equitable manner, they have never been required to act in the best interests of the client, nor are they required to disclose conflicts of interest. A brief history of these matters can be found in our First Quarter, 2010 issue of *Investment Quarterly* [“The Fiduciary Flap: Should Advisers Be Required to Put Client Interests First?” at www.schultzcollins.com/files/IQ2010Q1.pdf]

The term Independent Investment Counsel also derives from the 1940 Act. It signifies a Registered Investment Advisor with no formal contractual obligations or informal associations with Broker/Dealers, Banks, Custodians, or other elements of the financial services industry. The SEC defines investment counsel as, “an individual, institution, organization, or department of an institution or organization

which undertakes for a fee to advise or to supervise the investment of funds by, and on occasion to manage the investment accounts of, clients.” The 1940 Act defines “investment counsel” as a subset of the “investment advisers” to whom the Act applies. By extension, an Independent Investment Counsel firm does not seek to use RIA services as a springboard to create security sales opportunities.

SCLC acts in the capacity of Independent Investment Counsel. Some of our advisory representatives are also registered representatives of a broker/dealer [Financial Telesis], solely to facilitate administrative requirements in the supervision of client accounts. Financial Telesis imposes no sales quotas, agenda, product menus or other requirements that constitute a conflict of interest. This is a critical distinction for trustees because, in some areas of the country, the RIA designation is fast becoming a code term for security salesperson.

A SAMPLE CASE

The following fact pattern is culled from a number of trust litigation cases. The primary goal is to demonstrate the importance of “issue awareness” when dealing with hybrid model RIA practitioners.

Following the creation of a testamentary family trust, a family member accepted appointment to the office of trustee. Included in the trustee’s responsibilities was the duty to invest trust assets for the benefit of several beneficiaries. The trustee had a long-standing relationship with a stockbroker, and turned to the broker for advice on how best to discharge investment responsibilities. The broker, in turn, acquainted the trustee with a program that his firm makes available to accounts greater than \$1 million. The broker/dealer identifies “world class” private money managers for a cross section of asset classes. For example, clients could select to place a portion of their funds with a large-cap U.S. stock manager with a history of outperforming the S&P 500 index. Similar selections are available for small-cap stock investments, foreign investments, fixed-income investments, and so forth. The elite private manager program was marketed as a fund-of-funds where each asset class component is managed by “the best of the best.” The implication of the investment structure is that a trustee can demonstrate investment prudence by virtue of the historical track record of the private money managers participating in the program and by virtue of the broker/dealer firm’s seal of approval.

The investment program was structured as a “wrap account.” A wrap account charges a single fee to cover all qualifying expenses, including fees to the broker/dealer, fees to the individual private money managers, and other explicit administrative expenses involved with account maintenance and reporting. In this case, the wrap fee does not cover preparation of the trust’s tax return, and, in this case, is in the neighborhood of two percent annually.

Fast forward three years. The portfolio has performed poorly relative to the commonly used asset class benchmark indexes. For example, instead of outperforming the S&P 500 index, the “world class” large-cap stock manager has lagged it by more than fifteen percent over the three-year period. The trustee receives written communication from the broker dealer thanking him for participation in the private money manager program, counseling him that investors should retain a long-term focus, and informing

him that the firm replaced the U.S. large-cap manager with another manager possessing a market-beating track record.

This fact pattern suggests a number of interesting questions. Why, for example, would a “world class” private manager open its doors to a flood of small accounts from mass-marketing broker/dealer firms, when there is strong evidence that beyond a certain size, a fund’s performance begins to mirror that of the market as a whole? Why is there a seeming lack of consistency and persistency in the track records of “world class” managers? Aside from the explicit two percent fee, why are trust assets underproductive? Are account values lagging relevant benchmarks because the private money managers have lost their investment skills? What questions should the trustee ask? What should the trustee have asked before he signed the wrap account participation agreement forms? [In investigating one wrap fee program offered by a prominent broker/dealer firm, it was amusing to discover that their line-up of “world class” managers often changed—it was rare to see the same line-up for more than two years in a row].

Here is a simplified theory. We know that the “world class” managers must agree to participate in the wrap account program according to the terms negotiated with the referring broker/dealer firm. We can further assume that a participating money manager agrees to place all trades for referred clients with the referring firm’s trading department. The agreement, of course, specifies that the referring firm has the obligation to assure that submitted trades are executed at the NBBO price or better. But now, each money manager has two sets of clients: (1) the original clients for whom the manager is free to seek any trade venue offering low-cost liquidity, and (2) the referred clients for whom all trades must be directed to the referring firm. Assuming that the trading costs for the latter population are higher than those for the former, the money manager has a fiduciary duty to segregate his trading operations—after all, it would not be proper for the first group of clients to subsidize the costs for the second. Further, assume that the money manager sequences trades. This means that he submits trades for his proprietary customers—the population group on which his track record was built—prior to submitting the trades of the referred clients. For example, assume that the manager wishes to sell 500,000 shares of XYZ stock. Presenting the entire order to the market in a single block would require a substantial price concession. The manager therefore utilizes a trading algorithm based on balancing volume, price, and trade timing. The first shares submitted to the market are sold at the highest price, and as the market adjusts to the manager’s demand-to-sell schedule, each new piece of the order sells for an incrementally lower price. When the manager has sold the shares attributable to his proprietary customers, the average price of the sales so far is assigned pro-rata to their accounts. At this point, when the market price is already depressed by the impact of trades he has submitted on behalf of his proprietary accounts, the manager submits the remainder of his order to the referring firm’s trading department, which proceeds to fill it at the now depressed price at the NBBO. To the extent that the money manager’s track record reflects trading skill in addition to investment selection skill, the referring firm’s clients cannot benefit from it. They are last in line in a competitive trading environment. When it comes to price paid or price received, they always draw the short straw.

There is nothing illegal happening here. All parties are fulfilling their duties as defined by the regulatory authorities. However, the trust is hemorrhaging money in ways which may be completely opaque to an

unsophisticated trustee. All trading procedures are fully disclosed in the investment agreement. However, the “losses” from trade sequencing alone may exceed the explicit wrap-fee costs associated with the program. Ironically, the marketing materials promoting many wrap fee programs often emphasize a low-cost, single-fee, no-hidden-charges approach to investing.

Trustees wishing to delegate investment management have a duty to assure that the delegation is prudent. Not all financial advisers are fiduciaries. More disturbing, many RIAs offer investment advisory agreements that enable their evasion of a wide range of fiduciary standards of practice through disclosures of potential conflicts of interest. Although full disclosure is good, it increases the burden on trustees to evaluate the provisions of the investment advisory agreement lest the trust agree to cede important economic protections.

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