

**ENVESTNET.**



## **Fiduciary Hot Spots**

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# Investnet at a Glance

ENVESTNET

- Founded in 1999
- Supporting more than 21,000 advisors worldwide and more than 910,000 investor accounts\*
- More than \$139 billion in total platform assets\*
- 450 employees in offices in Chicago (Headquarters), Boston, Charlotte (NC), Denver, New York, Sunnyvale (CA) and Trivandrum, India
- Supporter of the fiduciary standard through technology and membership in the Committee for the Fiduciary Standard





**James Patrick, Managing Director**  
**[james.patrick@investnet.com](mailto:james.patrick@investnet.com)**

Jim is responsible for leading the efforts in the development and distribution of Investnet's advisor managed offerings.

Prior to joining the firm, Jim was a Consultant to financial services firms after 12 years with Allianz Global Investors. At Allianz, Jim held various roles within sales, product development, and national accounts across a variety of channels. At the time of his departure, Jim was Managing Director, Co-Head of US Retail Distribution for Allianz's equity capabilities and PIMCO. Before that, he worked at Nicholas-Applegate Capital Management since 1997, prior to their acquisition by Allianz in 2001. Jim also served as General Manager and a principal of City Sports, Inc. in Boston for 5 years and worked for RECOLL management.

Jim holds FINRA Series 7, 66, 24, 26 licenses and gained the CIMA designation in 1998. Jim holds a BS in Business Administration from the University of New Hampshire.



**Michael Koffler, Partner**  
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Michael Koffler, a member of Sutherland’s Financial Services Practice Group and head of the firm’s Investment Adviser Team, focuses his practice on the investment adviser and broker-dealer industries. Michael works on securities issues associated with the management and distribution of investment products by financial institutions, including investment advisers, wirehouses, banks, independent broker-dealers and insurance companies.

Prior to joining the firm, Michael spent two years on the staff of the U.S. Securities and Exchange Commission (SEC) in the Division of Investment Management, where he reviewed registration statements, no-action requests, exemptive applications and proxy statements. Michael also helped promulgate SEC rules and answer interpretive questions from financial institutions.

# WHAT IS A FIDUCIARY HOT SPOT, ANYWAY?

How well do advisors understand their obligations as fiduciaries?

# Implications of Being a Fiduciary

## SEC v. Capital Gains Research, Inc. (1963)

- Supreme Court recognizes IAs as fiduciaries to clients
- IAs must eliminate, or at least expose, all conflicts of interest that might cause them to provide advice that is not disinterested
- Disclosure obligation is derived from the duty of loyalty

## SEC has interpreted Capital Gains as requiring IAs to, among other things:

- Manage portfolios in the best interest of clients;
- Provide clients with “undivided loyalty”;
- Make full and fair disclosure of all material conflicts of interest;
- Seek best execution for client transactions;
- Ensure that investment advice is suitable for clients’ objectives, needs and circumstances; and
- Refrain from effecting personal securities transactions inconsistent with client interests

**Fiduciary law vests entrustors the legal right to rely on integrity of fiduciaries and quality of the services they provide**

## Disclosure:

- Generally, fiduciaries must disclose all material facts regarding conflicts to enable clients to make informed decisions whether to hire, continue the relationship or take action to protect themselves
- Facts and circumstances analysis

## Suitability (both IAs and BDs have suitability obligations):

- FINRA Rule 2111
- Advisers Act: read into anti-fraud provisions and IA-1406

## Conflicts:

- Need to conduct ongoing monitoring and reviews of conflicts of interest
  - “Things happen” (business developments) – create/heighten conflicts*
- “Inventory” practices, relationships and roles that create conflicts – track on ongoing basis
- Implement processes and procedures to identify and mitigate conflicts (matrix)
- Where impossible to avoid conflicts, fully and fairly disclose conflicts
- Review account forms and documentation to ensure all conflicts are appropriately disclosed



# Costs, Complexity and Conflicts (The “3 Cs”)

- **Scrutiny of “3 Cs” – Costs, Complexity and Conflicts** - stems from duty of loyalty and duty of care and the requirement to act in clients’ best interest
- **Expect SEC/FINRA to review** how firms come to recommend costly/complex/conflicted securities
- **Firms have to justify** why costly/complex/conflicted securities are recommended, particularly if alternatives are available
- **Possibility**: Suitability justification may come to resemble the soft dollar analysis conducted by IAs under the safe harbor in Section 28(e). Firms should expect to be asked to justify why the beneficial features of a recommended security justify its costs/complexity/conflicts
- **Documenting** rationale for recommendations
  - *Essential to be able to evidence analysis that was conducted and demonstrate that recommendation was in best interests of client*

# Costs, Complexity and Conflicts (The “3 Cs”)

- Fiduciary duty **should NOT result in a “race to the cheap or simple,”** in which firms can only recommend cheapest/simple securities available
- Nor does it seem that a firm’s business model will be legislatively mandated (**model neutrality**)
- **Recommending cheapest/simplest/non-conflicted security may not be in the best interests of client**

# Costs, Complexity and Conflicts (The “3 Cs”)

## Must:

**Ensure you evidence that the benefits of a recommended security justify its cost/complexity/conflicts and any other negative attributes**

- Requires recommending securities that match clients' needs
- Requires evaluating whether there are reasonably available alternatives that better meet client's needs

## Must NOT:

**Recommend securities with features clients do not need or want**

- Are there feasible alternatives available with similar benefits but without the features that are not needed or desired?

## Truism

Where two securities meet a client’s needs but one is more costly/complex/conflicted than the other, then, *everything else being equal*, recommend the less costly/complex/conflicted. What about the real world?

Where there are security differences, weigh and judge the value attributed to such differences

- Cost/complexity/conflicts are factors, but not necessarily the most important factors
- How much of a factor? Depends on the facts and circumstances

## Truism

Some differences may be qualitative and thus difficult to quantify. Others may be quantitative and thus easy to measure.

- Involves judging a host of qualitative and quantitative factors
- It's as much art as science
- Analyze differences and **document** reasoning underlying analysis

## Key Standard

Does the documentation, viewed fairly and objectively, support the conclusion that the advice/recommendation satisfies the goals, objectives and needs of the client as well as, or better than, other reasonably available alternatives

## IT'S ABOUT PROCESS

1. Consider **how advice and recommendations compare to reasonably available alternatives** – securities cannot be viewed and considered in isolation.
2. Satisfying the standard above becomes more difficult when one of the “3 Cs” is present, particularly if the firm has a financial interest in the recommended security (e.g., security is issued by an affiliate, the firm/rep earns more compensation from recommended securities than alternatives, etc.).

## Consider ways to neutralize and mitigate these conflicts

### Examples:

- Review data to see if there is evidence that financial incentives skewed the advice provided
- Fully and fairly **disclosing** the nature and extent of any conflict before the client makes an investment decision
- Implementing policies and procedures to ensure adequate **supervision of recommendations** of “3C” securities – have persons **insulated** from the conflict review and analyze advice provided
- Requiring a **written explanation** by a rep of why a “3C” security is in the best interest of the client and a review of explanation by a supervisor;
- Preparing and reviewing **exception reports** tracking “3C” security recommendations



# Implications of Being a Fiduciary: Ongoing Monitoring

## Traditional Characteristic of a Fiduciary vs. Dodd Frank Language

Conducting ongoing security due diligence and “know your client” reviews

### Chairman/CEO of FINRA

- Goal – know essential facts concerning client (e.g., financial profile and investment objective)
- This information may be used to aid the firm in all aspects of client relationship

### Need policies and procedures to:

- Periodically monitor securities recommended/sold to clients as well market conditions for such securities and assess whether securities continue to be in best interests of clients
- Periodically meet with clients to determine whether there have been any changes in clients’ financial situation or investment objectives
- Promptly communicate with clients if assumptions or expectations concerning operation of a security materially changes

## Possibility of Rulemaking By Enforcement

# Importance of Documentation

- Satisfying a standard of care  $\neq$  proving the standard was satisfied
- FINRA and SEC examiners' working assumption: if something cannot be proved, then it did not happen
- A statutory fiduciary duty will make it even more important for BDs and IAs to document the processes undertaken to satisfy fiduciary obligations.
  - Client information obtained and considered
  - Asset allocation creation, suitability, risk assessment, and customization of customer advice
  - Research and due diligence conducted, including the factors considered and analyzed, and conclusions reached;
  - Communications and disclosures made to clients, both written and oral;
  - Portfolio construction process;
  - Asset management decisions, including supporting analytics;
- Billing of client accounts, including how fees/charges calculated;
- Account funding and opening mechanics;
- Account and portfolio reviews and monitoring (*e.g.*, drift/trade alerts)
- Reconciliation, data aggregation and performance reporting.

# Implications of Being a Fiduciary: Training

Becomes more important in a fiduciary world

Focus on:

- Disclosure
- Compensation
- Suitability
- Conflicts of Interest
- Documentation

Rep and Supervisor levels

Train on use of forms, systems and technology

# Implications of Being a Fiduciary: Recruiting

## “YOU ARE WHAT YOU RECRUIT”

### Everything follows from the hiring process

- Due Diligence - dig beyond any black marks
- Review business and regulatory background – composition and mix of business, conflicts that would be created, sources/percentage of revenue sources, number of clients
- Know the person - look beyond the numbers
- Notion of suitability - is the rep suitable for the firm – a good fit?

Danger: *making exceptions* from firm standards for advisors with large books of business

The “platform of exceptions” -- lack of planning and managed growth of products. Many firms historically have not conducted formalized risk assessments when bringing over reps - so firms took on a lot of risk without much consideration (or even realizing it)

- We believe that the fiduciary standard creates new opportunities for advisors to build relationships of trust with clients.
- Research confirms that clients assume advisors are acting on their behalf.
- Regardless of who ultimately is designated as regulator of advisors, there will undoubtedly be additional costs and complexity.
- Some smaller practices in particular will find compliance more onerous and costly, which may lead to
  - Better and more efficient practice management
  - Industry consolidation as practices combine to realize efficiencies



## Change All Around Us

- **Dodd Frank**
- **Regulatory Enforcement**
  - Section 913 Study
    - Staff Study, Dissent, Passing on the Tough Issues
  - Future Rulemaking
  - FINRA as an SRO?
- **Increased Demand by Clients**

# Hot Spot #1: Paradox of Disclosure

Is disclosing potential conflicts of interest the solution to meeting fiduciary requirements? Or is disclosure just a cop-out?

- Add Daylian Cain's research here – the more disclosure, the less likely investors are to process it.

# Hot Spot #2: Retirement Income

- What are the best ways to set up a decumulation portfolio? How should a fiduciary advisor address retirees' emotional concerns about assets?
- Is what's best for retirees in conflict with what's best for advisors?
- When funding is not-so-spectacular and the client is worried, is there a role for annuities? (Before you shout "NO," understand that economists from Alicia Munnell to Zvi Bodie insist that there is.)
- Are advisors facing their own biases about "committing annuicide"?



## Hot Spot #3: To fee or not to fee

Fees are okay, commissions are okay. Hidden costs are not okay. How far does an advisor have to go in disclosing hidden fees to meet a fiduciary standard? Is it possible to have complete transparency?

- Do you know which product providers pay to be on your custodian's or broker-dealer's platforms?
- Do you know how much they pay?

## Hot Spot #4: Broker-dealer culture

The logo for ENVESTNET, featuring the word "ENVESTNET" in a bold, blue, sans-serif font. The logo is positioned in the top right corner of the slide, partially overlapping a dark blue header bar and a light gray background. The background of the slide features a geometric pattern of white lines forming a star-like shape against a dark blue background.

How do you transition a sales-based, fee-based culture, with a suitability state of mind and hidden trails, to meet the new requirements of a fiduciary standard?

# Hot Spot #5: Formalization

Creating and sustaining a genuine fiduciary process is arduous.

How can technology help?

Top-performing firms use technology to

- Achieve efficiencies
- Deliver the desired client experience

Technology can help you achieve better control over your practice and satisfy fiduciary standards.

Investnet's Fiduciary Oversight Notes (FONs) help advisors engage in and document a fiduciary process

# Fiduciary Oversight Notes (FONs)

ENVESTNET

ENVESTNET Advisor Console  
Signed in as Model Advisor [Return](#) | [Classic UI](#)

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The Grossman Family: Sample Account Moderate Growth: \$1,000,000

**Asset Identification**

The Current Investment Assets entered in this section should be assets designated to achieve a specific investment objective. Some assets will be liquidated then invested ("investable") while other assets will be retained and managed as part of the proposed, new investment solution. Please review your client's overall financial situation and investment objectives to determine all assets which should be considered when building this proposal.

[Close](#)

**Current Investment Assets**

| Asset Description or Ticker | Investable                          | Delete |
|-----------------------------|-------------------------------------|--------|
| Cash                        | <input checked="" type="checkbox"/> |        |
| Total: \$1,000,000          |                                     |        |

[Add by Asset Class](#) [Add by Ticker](#) [Import Holdings](#)

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| ID | Advisor        | Form                | Answer                         | Date Created |
|----|----------------|---------------------|--------------------------------|--------------|
| 3  | Advisor, Model | Proposal Generation | Allocation: expect adjustments | 6/22/2010    |
| 3  | Advisor, Model | Proposal Generation | Invested assets only           | 6/22/2010    |
| 3  | Advisor, Model | Proposal Generation |                                | 6/22/2010    |
| 3  | Advisor, Model | Proposal Generation | Allocation: safety             | 6/22/2010    |
| 3  | Advisor, Model | Proposal Generation | Risk Profile: explanation      | 6/22/2010    |

- Proposal Activity
- Advisor Activity
- Sales Activity
- Closed Account Activity
- Billing Activity
- Fiduciary Oversight**
- Requests
- Tasks
- Manager Analysis

\*Screenshot contains sample data. It is not representative of any client, money manager or custodial information and should not be construed as such.

**Thank you very much.**

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