

Conflicts of Interest: Discovery, Mitigation, Disclosure

Johann Klaassen, PhD, CFP®, AIF®
Chief Investment Officer & Executive Vice President
johann@HorizonsSFS.com



Disclosure / Disclaimer

Johann Klaassen is an ACCREDITED INVESTMENT FIDUCIARY™, the professional designation certifying competency in the area of fiduciary responsibility. Johann is also a CERTIFIED FINANCIAL PLANNER™ certificant.

He is an Investment Advisor Representative of Cambridge Investment Research Advisors, INC., a Registered Investment Advisor. Horizons Sustainable Financial Services is not an affiliate or subsidiary of Cambridge Investment Research.

He subscribes to a package of professional services offered by First Affirmative Financial Network, LLC (FAFN). He is not an investment advisory representative of FAFN. First Affirmative is not an affiliate or subsidiary of Cambridge or Horizons Sustainable Financial Services.

Johann does not personally own any shares of any of the specific companies he might mention in the course of this presentation.

Nothing in this presentation should be interpreted as investment advice, or as an offer to buy or sell securities.

Any performance figures contained herein are based on information sources believed to be reliable, and are not to be interpreted as a guarantee of future results.

The views expressed herein are my own, and not those of Cambridge Investment Research or Horizons Sustainable Financial Services.

Asset allocation and diversification strategies cannot assure profit or fully protect against loss. Indices mentioned are unmanaged and cannot be invested into directly.

Purpose of Session

Fee-only advisors like to believe that we have, by our choice of compensation structure, eliminated all conflicts of interest with our clients. But it's just not true.

In this session, in typical philosophical fashion, we will make a few distinctions and draw a few conclusions – which I hope will shed some light on the problem, and suggest some real-world solutions.

First: Who Am I?

Previous

2001-2012: Vice President for
Investment Services

First Affirmative Financial Network

Colorado Springs

Current

2013: Chief Investment Officer &
Executive Vice President

Horizons Sustainable Financial
Services

Santa Fe, NM & Palmer Lake, CO

First: Who Am I?

Academic

BA, Saint John's College –
Great Books (1992)

PhD, Washington University
(St Louis) – Philosophy
(Ethics & Social Phil, 1998)

Professional

AIF®, November 2003
(certificate #70)

CFP®, June 2010
(certificate #151953)

Money holds power.

There is a key component of Sustainable, Responsible, Impact Investing that brings light to that power. By leveraging the economic influence of the more than 3 trillion dollars invested by regular people like you and me, we can be a major catalyst for change in our world.

“Typical” Claims about Conflicts

AnonymousFinancial.net/Fee.html

What is fee-only financial advice?

Fee-only financial advice, as distinguished from commission-based sales, is advice delivered in exchange for a fee. Since the recommendations do not affect the advisor's compensation, **the advice is objective and free from conflicts of interest.** There is no sales pressure. Fee-only advisors provide personalized non-commissioned based financial advice. You and your advisor should have the same objectives.

— note: real quote, not the real URL.

Key Questions

1. Why are we here?

What makes “conflict of interest” a topic for today?

2. What are we talking about?

What is a “conflict of interest”?

3. Okay, but what does that mean?

What if your fundamental premise is false – what then?

4. What is to be done?

Can mitigation and disclosure solve all our troubles?

Why Are We Here?

- CFP Board: “Recent uptick in conflict of interest cases.”

Background

- CFP® professionals routinely deal with conflicts of interest in their practice
- Recent uptick in conflicts of interest cases
- Provide guidance on compliance with the *Standards of Professional Conduct* (“Standards”) regarding conflicts of interest issues
- Awareness of conflicts of interest issues protects both clients and CFP® professionals

CFP BOARD

Why Are We Here?

- CFP Board: “Recent uptick in conflict of interest cases”
- Fi360: “Regulators are Concerned with Conflicts of Interest”

Regulators are Concerned with Conflicts of Interest



- SEC: Speech of Robert di Florio, Director of OCIE (October 31, 2012)
- FSA: Conflicts of Interest Between Asset Managers and Their Customers (November, 2012)
- CSA: Consultation Paper “The Standard of Conduct for Advisers and Dealers” (October 25, 2012)

7

Why Are We Here?

- CFP Board: “Recent uptick in conflict of interest cases”
- Fi360: “Regulators are Concerned with Conflicts of Interest”
- Ethical Issues?

What Are We Talking About?

Black's Law Dictionary:

“A ‘conflict of interest’ is a clash between public interest and the private pecuniary interest of the individual concerned.”

How CFP Board defines a Conflict of Interest

- CFP Board's Terminology Section: A conflict of interest exists when a CFP® professional's financial, business, property and/or personal interests, relationships or circumstances reasonably may impair his/her ability to offer objective advice, recommendations or services.

CFP BOARD

6

What is a Conflict of Interest?



- SEC (di Florio): “A scenario where a person or firm has an incentive to serve one interest at the expense of another interest or obligation”
- fi360 – Conflict of interest in a fiduciary context: “A circumstance that makes fulfillment of the duty of loyalty less reliable”

4

“Fiduciary”?

CFP Board on Fiduciary Status:

“**Fiduciary**”: One who acts in utmost good faith, in a manner he or she believes to be in the best interest of the client.

While CFP Board’s fiduciary standard is reserved for financial planning services, the *Standards* nevertheless require a high duty of care for all CFP[®] professionals in any type of client relationship: “A CFP[®] professional shall at all times place the interest of the client ahead of his or her own.” [See Rule 1.4]

The “Common View” of Fiduciary Status

A “fiduciary relation” establishes a situation in which various professionals “in equity and good conscience” are “bound to act in good faith and with due regard to the interests of the one reposing the confidence.” When professionals are viewed as fiduciaries, they are thought to be bound to act as if their interests were those of their client and hence to sacrifice their own interests for the sake of their clients’ interests.

— Larry May, *The Socially Responsive Self: Social Theory and Professional Ethics* (U Chicago Press, 1996), pp. 135-36.

Fiduciary Professionals

“The paradigm of a responsible professional, so it is often said, is that person who can scrupulously avoid conflicts of interest by keeping personal considerations out of his or her professional judgments.” (May, p. 123)

How?

Rules?

CFP Board's Conflict of Interest Rules

- Rule 1.4 – The CFP® professional must place the interest of the client ahead of his or her own. If providing financial planning services, must act as a fiduciary.
- Rule 2.2(b) - The CFP® professional must disclose to a prospective client or client a general summary of likely conflicts of interest.
- Rule 4.1 - The CFP® professional must treat prospective clients and clients fairly and provide **professional services with integrity and objectivity.**

CFP BOARD

CFP Board Rules of Conduct, Rule 2.2:

A certificant shall disclose to a prospective client or client the following information: ...

b. A general summary of likely conflicts of interest between the client and the certificant, the certificant's employer or any affiliates or third parties, including, but not limited to, information about any familial, contractual or agency relationship of the certificant or the certificant's employer that has a potential to materially affect the relationship.

Fiduciary Professionals?

A responsible professional “is often conceived as someone who conscientiously conforms to a set of strict obligations. So, in discussions of professional ethics, quite a bit of time is spent trying to delineate an ideal set of these obligations ... Indeed, it is often said that the model of the socially responsible professional is someone who disregards all factors except his or her professional obligations.” (May, p. 5)

Fiduciary Relationship Models

Whatever may be the models that obtain in other legal cultures, the client-lawyer relationship in the United States is founded on the lawyer's virtually total loyalty to the client and the client's interests.

— Charles Wolfram, *Modern Legal Ethics* (West Publishing, 1986), p. 146.

But this view is **unrealistic** and **deceptive**.

Okay, But What Does That *Mean*?

Unrealistic:

- How can I objectively determine your interests?
Your “best” interests?
- How can I completely shut out my own interests?
Does the question even make sense?

Deceptive:

- Doesn't this view create a false expectation of perfect loyalty?

What Does *That* Mean?

But ... What's *wrong* about conflicts of interest?

- They involve deception.
- They infringe client autonomy.
- They allow those in positions of responsibility to **take advantage of the vulnerable.**

Rules? Or Responsibilities?

Will more rules help us avoid deceiving, manipulating, or taking advantage of our clients?

Might an “ethic of social responsibility”, which asks us to attend to / respond to those who are vulnerable, be a better way to inspire the kind of behavior we want?

“An Ethic of Social Responsibility”

Those who display social responsibility are those who take responsibility for the facts about their societies over which they have at least some control. Socially responsible individuals are attentive and sensitive to the social conditions of their communities, large or small. ... The main features of this conception of social responsibility are attentiveness, sensitivity, and responsiveness to the social world within which an agent resides.

“An Ethic of Social Responsibility”

An ethic of *social* responsibility shares certain features with some consequentialist theories in forcing us to think about the social consequences of our actions, attitudes, and character traits. But social responsibility does not necessarily involve a maximization (or even an optimization) strategy. ... What is necessary is that the socially responsible person *take responsibility for* these consequences. (May, p. 102)

Practical Issues

Classic example of a conflict:

Invest an inheritance, or pay off a mortgage?

Practical Issues

Prior example of a conflict:

Why should I hire a financial planner / investment advisor at all?

Practical Issues

Fundamental practical problem:

Every client's first interest is to get the best advice for the lowest financial commitment (ideally, \$0). Advisor's first interest is to get the highest possible fee for the lowest time and resource commitment.

Real Solutions?

- Some conflicts can be avoided by attentively structuring our business arrangements.
- Some conflicts can be mitigated, if not eliminated, by disclosure.
- But some conflicts will unavoidably remain, and be serious problems even if disclosed. What can we do for / about those?

