

Understanding the Distinctions:

- **Suitability vs. Fiduciary**
- **Compliance vs. Fiduciary Culture**

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A Necessary Disclaimer:

These are my views alone – not those of Alfred State College, nor any organization, board or committee of which I am a member.

Nor are these views necessarily the same views of our host, fi360.



AGENDA

- **Update: “Uniform Fiduciary Standard”?**
- **Rules- vs. Principles-Based Standards**
- **What is a “Profession”?**
- **Suitability vs. Fiduciary: Duty of Loyalty**
- **Suitability vs. Fiduciary: Duty of Care**
- **“Compliance” vs. “Fiduciary Culture”**
- **Training Your Team**

A “Uniform” Fiduciary Standard?

ERISA

IAA

DODD-FRANK FOR BD’s

Rules-Based Standards of Conduct **vs.** Principles-Based Standards of Conduct



Securities “Professional”?

The Maloney Act Failure

The Advisors Act Failure

“Professional” - “A true professional uses his or her ability and power solely to advance the best and truest interests of the client. When the professional’s interests diverge from those of the client, the professional always follows only the client’s interests.” – Prof. Steven G. Blum, “A New Professionalism” (2009)

Why Should I Trust You?





The Elements of Trust

- **Expert**
- **Best Interests**
- **Candor**



The Elements of Trust

- **Expert Due Care**
- **Best Interests Loyalty**
- **Candor Utmost Good Faith**

“The Fiduciary Principle”

Bristol and West Building Society v. Matthew (U.K., 1998) - Lord Millet:

“A fiduciary is someone who has **undertaken to act for and on behalf of another** in a particular matter in circumstances which give rise to a **relationship of trust and confidence**. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principle is entitled to the **single-minded loyalty** of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of the fiduciary obligations. They are the defining characteristics of a fiduciary.”

Fiduciary Duty – NOT MERE Disclosure

**If disclosures worked,
there would be no need
for fiduciary duties.**

Fiduciary Duty as the Adoption of Ends



Suitability vs. Fiduciary: Duty of Loyalty

BDs – No “Duty of Loyalty”

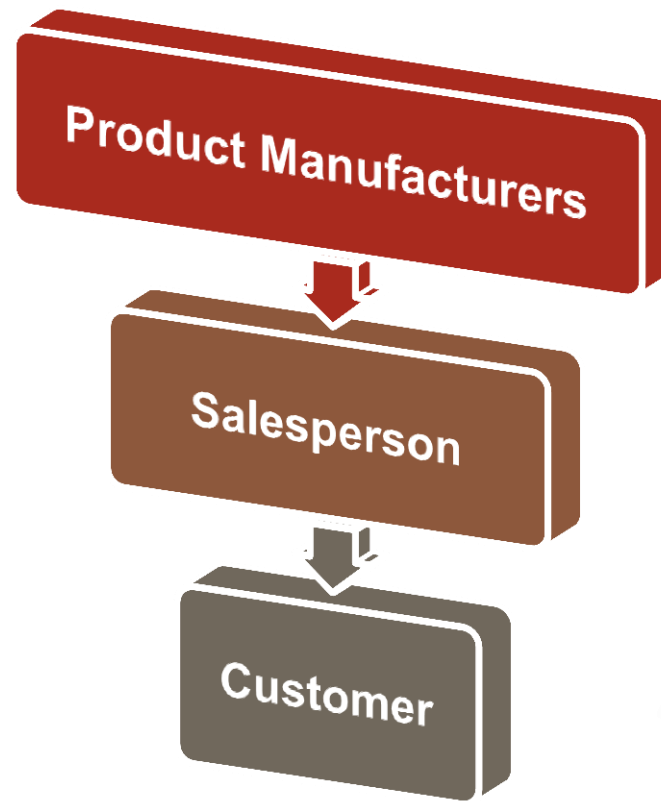
Suitability addresses *duty of care*
However - casual disclosure of
conflicts of interest is required.

IAs - Fiduciary Duty when Conflicts of Interest are Present:

- Duty to Avoid ?
- Duty to Disclose
- Duty to Ensure Client Understanding ?
- Duty to Obtain Informed Consent
- Duty to Act With No Harm to Client ?

Fundamentally ... *Two Types of Relationships*

ARMS-LENGTH RELATIONSHIP

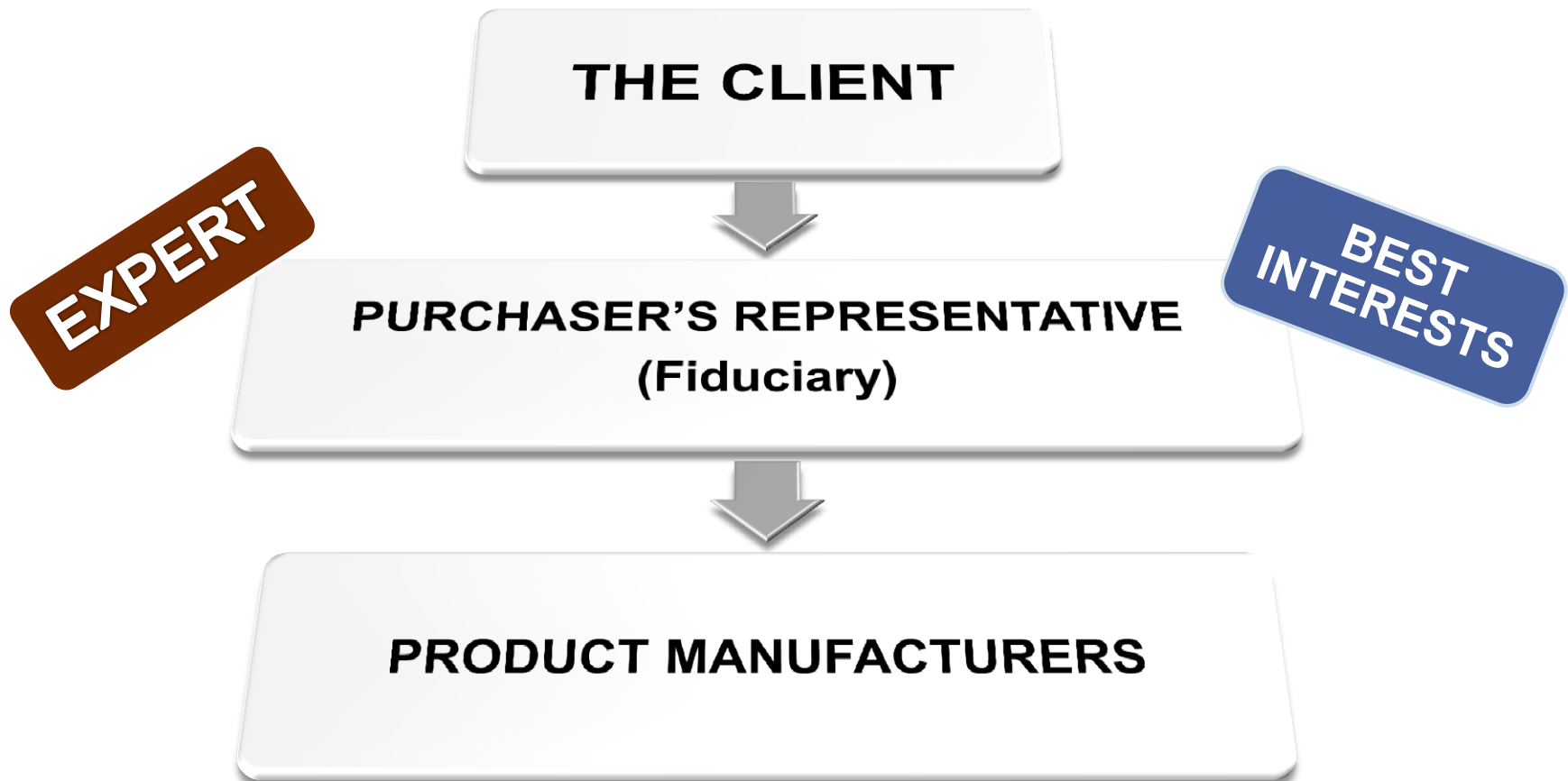


ARM'S LENGTH



Fundamentally ... *Two Types of Relationships*

FIDUCIARY RELATIONSHIP



The Inherent Difficulty of “Two Hats”



Suitability vs. Fiduciary: Duty of Care

Underwriter's Due Diligence Obligation

The “Reasonable Basis” Requirement: “By holding itself out as a ***securities professional*** ... a municipal underwriter also makes a representation that it has a **reasonable belief** in the **truthfulness** and **completeness** of the **key representations** made in any **disclosure documents**”

Failures: Violation of anti-fraud provisions

Violation of Rule 15c2-12

Source: SEC’s OCIE National Examination Risk Alert,, “Strengthening Practices for the Underwriting of Municipal Securities” (March 19, 2012)

SEC Concerns – *Municipal Underwriting Practices*

- 1. Not engaging in due diligence activities**
- 2. Not creating and maintaining written evidence of due diligence undertaken**
- 3. Failure to supervise dealer's employees**

(March 2012 alert)

SEC GUIDANCE – UNDERWRITERS: Maintain policies and procedures regarding your compliance with due diligence obligations

- **Specify the steps required to develop the “reasonable basis”**
 - Diligence “checklists” maintained
 - Required meetings with municipal officials; visits to facilities
 - Memorandum to record due diligence undertaken
- **Have *senior-level* committee review prior to commitment to underwrite the security**
 - Have business supervisors sign off on material prior to review by the commitment committee

Suitability vs. Fiduciary: Duty of Care

Independent (Non-Underwriter Affiliated) Broker's Due Diligence Obligation:

1. Reasonable Basis Suitability
2. Customer-Specific Suitability
3. Quantitative Suitability

“Unless a broker-dealer has performed **adequate due diligence** concerning a particular investment, especially an investment that does not trade regularly on an established market, it would be very difficult for the firm to prove that it had reasonable grounds for considering the investment to be suitable.”

- William E. Donnelly, Esq., “The Heightened Importance of Thorough Due Diligence in the Current Market Environment,” *Practical Compliance & Risk Management for the Securities Industry* (July-Aug. 2009)

Suitability vs. Fiduciary: Duty of Care

Investment Adviser's Due Diligence Obligation

In theory, fiduciary advisors select the *best product* to execute the *strategy*, not just a product that satisfies due diligence criteria.

Dodd-Frank expressly permits firms to have limited range of products.

“Compliance” vs. “Fiduciary Culture”

NOT JUST ADHERENCE TO RULES.

BE PREPARED TO DEFEND YOUR ACTIONS ...

“A transaction between a fiduciary and his (client) is **considered unfair** if the fiduciary **significantly benefits from it at the expense of the (client)** as **viewed** in the light of the circumstances existing at the time of the transaction ... Whenever a **fiduciary receives a benefit** or makes a profit from transactions with his principal, a **presumption of fraud, unfairness or undue influence** arises.”

Izzo. vs. Izzo, 2010 Tex. App. Lexis 3623 (May 14, 2010)

INSTILL A FIDUCIARY CULTURE:

- **Leadership**
- **Understand - “Why Fiduciary?”**
- **Compensation Methodologies**
- **Principal Trades vs. Order Aggregation**
- **Structure of the Firm**
- **Intense Due Diligence Process**
- **Team Education / Refreshers / Oversight**
- **Firm Altruism**

ADOPT A COMMUNICATION STRATEGY
FOR THE STANDARD BY WHICH YOU
FIRM ADHERES – To Your Team, Clients

**“We Are Professionals. We Advise.
We Serve. We Enable.”**

“We Provide Objective Advice.”

“We Care.”

“We Are Trusted Advisors.”

BUT: NOT JUST LIP SERVICE

BEST PRACTICES

**Agree to level compensation, in advance
- or *maximum* compensation**

COMMISSIONS ARE O.K. BUT ANY FORM OF
COMPENSATION THAT **VARIES** BASED UPON
RECOMMENDATIONS TO CLIENT IS PROBLEMATIC

**Disclose *in detail* - \$\$ amounts or percentage – receipt by
your firm or you of ... ANY material compensation from
third parties**

**Undertake Full Disclosures in Writing of Conflicts and
Compensation**

- at Time of Commencement of Client Relationship
- at Time of ***Each Transaction***

NOTE: **“CASUAL DISCLOSURES” ARE INSUFFICIENT**

When Conflict Of Interest Exists, Ask:

**“What Would I Do If My Parents /
Siblings / Children Were the Clients?”**

**NEVER HARM THE CLIENT in order
to receive an additional benefit
yourself.**

Investment *Strategy* Due Diligence

Possess an Investment Committee ... and
HOLD MEETINGS

Research and document your INVESTMENT STRATEGY

- why you chose the strategy
- why other strategies rejected
- Use back-testing and/or academic research
- Use much higher scrutiny for strategies which tout above-market returns

Investment *Product* Due Diligence

Evaluate ALL INVESTMENT PRODUCTS

- follow diligent process
- pay close attention to “total fees and costs”
- evaluate independent auditor
- evaluate the custodian
- verify third-party representations directly

Review periodically

Investment *Product* Due Diligence

Any Issuer:

- Examine offering statement, etc.
- Examine historical financial statements of issuer and affiliates (and footnotes!) – and ask: who is auditor?
- Google search: pending litigation, potential impact
- Is VALUATION reasonable?
- Much more detailed due diligence required for:
 - Reg D Offerings
 - Hedge Funds
 - Energy development/exploration programs
 - Virtually any “alternative” investment

Investment *Product* Due Diligence

Investment Companies (Mutual Funds, ETFs, UITs)

INITIAL SCREENING: Threshold Limits That Don't Pass MY Due Diligence Tests (as an RIA)

Excluded If:

- U.S. Stock Funds: AER > 0.60%
- Foreign Stock Funds: AER > 0.80%
- Bond Funds: AER > 0.30%
- Any Fund: **Any** 12b-1 fee or sales load
- Any Fund: **Any** payment of soft dollar compensation
- Any Fund: **Any** payment for shelf space
- Any Fund: Avg. cash holdings over past 1-5 years > 5%
- Any Stock Fund: (Reported) portfolio turnover > 40%
- Any Stock Fund: Securities lending revenue **shared with advisor**

Investment *Product* Due Diligence – Specific Questions

- **Variable Annuities:**

- Do the higher fees and costs incurred, and adverse tax consequences, justify the “guarantees” which are offered?
- Am I able to explain this product (and riders)?
- Is the client able to understand this product?

- **Equity Indexed Annuities (Fixed Indexed Annuities)**

- Are you able to explain how they work?
- Insurance company financial strength – a key issue
- Illiquidity – if sold to senior citizen, *per se* unsuitability?
- Adverse tax consequences (upon withdrawal, death)

Investment *Product* Due Diligence – Specific Questions

- **Reg D Offerings:**

- Do the higher fees and costs incurred, illiquidity and adverse tax consequences, justify the “guarantees” which are offered?
- Am I able to explain this product (and riders)?
- Is the client able to understand this product?
- Heightened due diligence – not mere reliance on issuer’s PPM
 - Examine issuer’s governing documents: ownership ties; perpetual existence; restrictions on activities
- “Red flags” trigger further, independent investigations

Can You Rely Upon Your Firm's Due Diligence?

Many advisers have had their careers destroyed by relying upon their firms and selling auction rate securities, structured notes, municipal arbitrage funds and the like.

NOTE AS WELL - The obligation to know a product is not fulfilled by listening to wholesalers.

AT A MINIMUM, RRs and/or IARs SHOULD:

- *Read and understand* the offering documents (for funds: prospectus, SAI, annual report, and semi-annual report)
- Understand all of the risks, fees, costs, tax and other characteristics of the product you are selling.
- Undertake a Google Search – by type of product, and for specific issuers
- Document **your** due diligence efforts and where you choose to rely upon firm's due diligence.

Best Practices

Client Profile

- Updated Annually
(at a minimum)



- **Points of Contact**
 - Define
 - Follow



- **TAKE NOTES**
(Always) ... and Retain Them

- **Add Specific Fiduciary Duties**
explanations to your firm's ...



Suggested Specific
Fiduciary Rules of
Professional Conduct for
RIAs

<http://www.dol.gov/ebsa/pdf/1210-AB32-PH029.pdf>

- **Train firm personnel**
 - Discuss hypothetical situations
 - Encourage “second opinion”
on proper management of conflicts



- **Adopt specific policies in the firm for:**
 - ***When clients should not invest, but rather should pay down debt***

While the “take a loan out” vs. “pay-down debt” decision is nearly the same, securities regulators are *much more suspicious* of advising clients to undertake leverage in order to invest.
 - ***When a fixed immediate lifetime annuity (preferably with CPI rider) should be recommended to a client***

**SAY WHAT
YOU DO**

**DO WHAT
YOU SAY**

Advocate Appropriate Regulatory Structure: PROFESSIONAL REGULATORY ORGANIZATION

Subject to appropriate government oversight, as *individual* professionals we adopt principles and rules for adherence to our:

- **Duty of Due Care**
 - Knowledge, expertise required for entry
 - Continuing education
 - Required peer review assessments
- **Duty of Loyalty**
- **Duty of Utmost Good Faith**

We are the best persons to educate our members and to enforce these standards.



THANK YOU!
**... Questions
and answers**