Before taking a self-imposed vow of silence, Ron Rhoades sounds off on the RIA industry and tells what's it's like to hit a professional wall The outspoken NAPFA chairman-who-wasn't covers why the Bachus bill will rise again, the true fix for RIA exams and why the term 'fee-based' is inherently 'fraudulent'

Monday 8.27.12 by Guest Columnist Ron Rhoades

Brooke's Note: What a remarkable week it was in the professional life of Ron Rhoades.

Last Monday, just 10 days before he was to assume the chair of NAPFA to do battle with the pro-FINRA forces in Washington, Rhoades announced that he would decline the post due to a compliance blunder on the part of his firm. The news caught the usually buzz-filled RIA business completely off guard. Colleagues reacted with incredulity and dismay: Incredulity that a person who has spoken out so passionately and with such erudition on fiduciary issues over the years could be caught out on such a rookie error and dismay at the sudden fall of a well-respected and well-liked colleague (to the point where Rhoades released a follow-up statement on Tuesday assuring the many who reached out to him that he was just fine). Still, for many, Rhoades' move raised more questions than it answered. Although all applauded his candor and practice-what you-preach ethos, many wondered whether the move was an overreaction to what most — though not all — saw as a relatively minor oversight. They worried that his abdication would do more harm than good at an all-hands-on deck moment in the evolution of the RIA business. By Thursday, the state of Florida had declined to levy a fine on Rhoades and reactivated the registration of his firm, ScholarFi. But there was no talk from any quarter — least of all Rhoades'— of walking back his decision. Shortly after the news broke on Monday, Rhoades reached out to RIABiz saying he'd like to share some valedictory thoughts on the industry before he withdrew, at least for the present, from the public advocacy sphere. Below, Ron, whose column, One-Man Think Tank, has appeared in RIABiz almost since its inception, canvasses a wide range of timely topics. Interspersed are some vivid nuggets about what it feels like to be caught out professionally in a very public way, his disappointment in himself, why his decision to step down "wasn't even a close call," and how he has made peace with the experience.

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RIABiz: There have been a lot of recent developments in Washington that may affect the fiduciary standard of conduct. What do you see as the most important recent development?

Ron Rhoades: Without a doubt the most important development of 2012, to date, was Rep. Bachus' introduction of a bill which would create a self-regulatory organization for all registered investment advisors. In reality the bill would place FINRA, the broker-dealer membership organization, in an oversight position over

their competition, independent investment advisers. This bill poses the biggest threat to RIAs in decades. See: Cheat sheet on Wednesday's Bachus fracas.

RIABiz: But didn't Bachus pull the bill? Even though he then came out with an Op-Ed in The Wall Street Journal a few days later, isn't the Bachus bill dead on arrival? See: *Amazed and confused: Advisors struggle to make sense of Bachus' Wall Street Journal Op-Ed salvo.*

The undead Bachus bill

RR: Not dead at all, just in the process of being amended. I fully expect a revised bill to be circulated among Republican House members, and perhaps reintroduced, this fall. The goal of Bachus' effort will be to get FINRA a foothold in RIA regulation with a more focused bill. He will seek co-sponsors and try to get the bill out of the committee and onto the House floor. At that point, Bachus would likely run out of time during this Congress. But the momentum would have been established for a new push in 2013.

RIABiz: What's different that might make FINRA oversight of RIAs more likely to be passed by Congress during 2013?

RR: During a non-election year, the Republicans will be more inclined to push the bill. This year any push for the bill might be seen to undermine the Republican platform, which in part favors the removal of various rules and regulations which endanger small businesses.

RIABiz: Why is Bachus pushing the bill so hard?

RR: FINRA and its allies and proxies, plain and simple. FINRA, despite its current budget deficit, spends a huge amount of money and time on lobbying-related activities each year. And the greater Wall Street community and insurance companies spend tens of millions of dollars on this and other related issues each year. They don't want that money to go to waste. With declining numbers of members, FINRA really wants to oversee RIAs.

In fact, after Bachus initially pulled the bill, FINRA made it known to him that the SRO bill is one of its top priorities and should not be dropped. That triggered the Wall Street Journal Op-Ed. I expect the Bachus bill will, with some changes, to be again floated in September.

RIABiz: Does the Bachus bill solve the oversight problem for SEC-registered RIAs, in that they only get examined, on average, only once every nine years?

RR: It does that, but at what cost? The estimates of the costs of FINRA oversight of RIAs are huge, even if one were to take FINRA's own estimates as gospel, which I don't. FINRA is currently in the process of raising fees on its own broker-dealer members — fee increases that the brokerage community has stated disproportionately impact smaller firms. See: *FINRA attacks Boston Consulting Group over SRO study.*

Regardless of how FINRA currently characterizes itself, it is controlled by the large Wall Street brokerage firms. Over the past decade, the number of small broker-dealer firms has declined precipitously. See: How a clique of industry vets plan to revive the swooning IBD space — and why industry watchers don't like their chances. If FINRA gains oversight of RIA firms, the small RIA-only firms will likewise face a huge challenge to try to stay in business, given the increased regulatory fees and compliance burdens FINRA will impose.

Just whistle

RIABiz:* But what is the alternative? How does one solve the problem of lack of inspection of RIA firms?

RR: Let's examine the problem carefully, first. A major role of government regulation of the securities markets, however it occurs, is asset verification. In other words, the government needs to make certain the customers' money is really there. I would submit that nearly all of the other compliance requirements which are reviewed during examinations pale in comparison to this essential government function.

That's because investors must possess confidence in our capital markets system. They must believe that the risk of loss of securities, due to actual fraud, is very, very small. While Securities Investor Protection Corp. insurance protects investors to a degree against loss of assets which may occur by conversion by a broker-dealer firm, such coverage is not as comprehensive as it could be. Moreover, when journalists cover another Ponzi scheme, it's not SIPC insurance or other insurance coverage which gets the headlines — it is the amount of customers' money which has gone missing that gets all the press.

If investors don't believe in our capital markets system, then they will put all of their money into commercial-bank deposits. This would bode ill for the cost of capital for corporate firms, and lead to stagnated growth. Much the same has occurred during the past century in Greece, where the cost of capital is high, due in large part to a long-standing custom of placing individual savings only in commercial banks. Large publicly traded corporations in Greece have always had difficulties with the cost of capital, which is one reason why so few exist, and part of the reason why Greece's economy has stagnated so much over the past few decades. The U.S. does not need to follow in Greece's footsteps, as could occur if consumer confidence is not restored in our financial services system.

RIABiz: Then how do we fix the RIA exam process?

RR: Through very frequent examinations, which focus on asset verification.

Time after time I hear of securities examiners, both federal and state, camping out at a small or midsize firm for two or three weeks. Typically such firms have either a handful of employees, or perhaps 20 or 30. So why camp out?

It seems to me that Ponzi schemes and other massive frauds are rarely uncovered during routine examinations. Rather, they are uncovered due to a customer complaint or employee whistle-blowing. See: *One-Man Think Tank: The SEC's custody examinations leave gaps big enough for Madoff to drive a bus through.*

So let me ask you this question: Why don't examiners interview each and every employee of an RIA firm in the presence of the chief compliance officer, and hand them a card with an e-mail address for whistle-blowing? That's how you can better uncover fraud.

RIABiz: But what about all the other books and records inspected during examinations?

RR: Nearly all of the documents requested during examinations can be examined remotely, and efficiently, through electronic document submission. An examiner stationed back at the SEC or state securities office can much more efficiently review these documents at his or her office, rather than on-site.

RIABiz: Won't examiners lose out on uncovering items that can be discerned only through on-site, comprehensive examinations?

RR: Perhaps. But when the examiners have limited resources, let's perform a cost-benefit analysis. Everyone in the securities industry needs fraud, when it occurs, to be detected early. It's that important — to the capital markets system and to securities professionals. We don't want frauds to grown to hundreds of millions of dollars, or billions of dollars. Frequent, highly focused exams, with employee interviews, is a great means to detect these frauds, when they are just in their infancy.

By contrast, most other compliance violations are minor. In fact, we have to ask — why are securities professionals not treated as professionals? The major difference is that other people's money is at stake. But — by and large — the custody of clients' assets can be inspected through very focused asset verification examination and employee interviews.

We must ask why attorneys or CPAs don't also receive regular visits from their own examiners. Other than the issue of custody of client assets, which can be solved by more-focused asset verification inspections, why are securities professionals treated so differently from other professionals?

What I mean is this: Doesn't the cost-benefit analysis fail, when we look at the resources devoted to examining all of these other items? Especially when resources are not devoted to a sufficient number of frequent, focused asset verification examinations. I'd rather have the SEC doing annual asset verification exams lasting one day for RIA firms, than doing comprehensive on-site exams lasting two or three weeks which occur only every decade or so. The SEC has to respect that it has a limited budget, and it must utilize its resources to combat major fraud. To do otherwise misses the mark — namely, sustaining confidence in our capital markets system.

RIABiz: You stated that detecting fraud is important to securities professionals themselves? Why so?

RR: How many times after the Madoff scandal did brokers, investment advisers and insurance agents need to sit down with clients and re-explain custody arrangements and the many safeguards existing for client accounts? It took a lot of time.

Moreover, when fraud occurs, it casts a poor light on all securities professionals, however they are regulated. Consumers seldom understand the nuances of "who is who" as to the type of licensure possessed; they just group all securities professionals together. Fraud by one hurts the reputation of all. It doesn't matter to consumers who was in charge of inspecting Madoff, or whether his firm was registered as a broker-dealer or an investment adviser. The Madoff fraud, when discovered, diminished confidence in all securities professionals, and undermined the confidence of investors so necessary for capital formation.

RIABiz: You've been a vocal critic of FINRA for much of this year. Why is FINRA the wrong choice for RIA oversight?

RR: There are many fine people who work at FINRA. But FINRA, formerly the NASD regulatory arm, has over its seven decades a history of lowering standards of conduct. It has resisted the application of the fiduciary

standard to the investment advisory activities of brokers, even though early on in its history NASD admitted that brokers were fiduciaries when providing investment counsel.

In one sense, all brokers have always been fiduciaries. Merely by taking custody of client assets they become agents, bound by a fiduciary duty to segregate and protect those assets, as that is the scope of their agency. In executing a trade as an agent, but not as a principal, a broker owes a fiduciary duty as well, which is commonly called the duty of best execution.

Broker v. dealer

RIABiz: But did brokers ever have the same broad fiduciary duties which were imposed on registered investment advisers by the SEC v. Capital Gains decision?

RR: Let me reply a couple of ways to that question.

First off, it was always known that the Investment Advisers Act of 1940 imposed broad fiduciary duties of due care, loyalty and utmost good faith upon RIAs. This was known back in 1940, both at the SEC and at NASD. The Advisers Act simply reflected state common law — as developed in court cases — which existed at the time. The Capital Gains decision thereafter merely confirmed that widely held view. The U.S. Supreme Court did not impose a fiduciary standard for the first time on RIAs; it had always existed on those who provide investment counsel.

Second, even NASD acknowledged, in 1940, that brokers providing investment advice were fiduciaries. This is what the NASD wrote publicly in 1940: *"Essentially, a broker or agent is a fiduciary and he thus stands in a position of trust and confidence with respect to his customer or principal. He must at all times, therefore, think and act as a fiduciary. He owes his customer or principal complete obedience, complete loyalty, and the exercise of his unbiased interest. The law will not permit a broker or agent to put himself in a position where he can be influenced by any considerations other than those to the best interests of his customer or principal … A broker may not in any way, nor in any amount, make a secret profit … his commission, if any, for services rendered … under the Rules of the Association must be a fair commission under all the relevant circumstances."* This is from The Bulletin, published by the National Association of Securities Dealers, on June 22, 1940.

RIABiz: Does that mean that all brokers, when providing investment advice, possess broad fiduciary duties of loyalty and due care?

RR: Early on in the jurisprudence of securities law it appeared that way. But then NASD, FINRA's predecessor, adopted Rules of Conduct for its members. But nowhere in those Rules of Conduct, despite what was widely known in 1940, did the NASD provide that the standard of conduct of a broker providing investment advice was that of a fiduciary. Rather, the NASD adopted the much lower, and now completely ineffective, suitability standard. See: *An in-depth analysis of FINRA's attempted takeover of RIAs and why the group should be disbanded, Part 2.*

The result was that, over time, the application of the fiduciary standard to brokers' advisory activities became less and less. Yet, there are still recent cases finding that brokers are fiduciaries, under state common law, applying a facts-and-circumstances test as to whether a relationship of trust and confidence has been formed

between the broker and the client. But back in 1940, it was much clearer cut. Brokers were fiduciaries. Dealers were typically not.

RIABiz: By "dealers," you mean broker-dealer firms when trading as a principal?

RR: Yes. I need to quote another NASD statement … the NASD stated early on *"that a dealer in securities was not a fiduciary, but rather a merchant … A member when acting as a dealer or principal in a transaction with a customer is acting essentially as a merchant, buying or selling securities for himself, for his own account, and like all merchants, hoping to make a profit of the difference between the price at which he buys or has bought for himself and the price at which he sells for himself. A member when acting as a dealer or principal is thus not subject to the common law principles of agency which apply to a broker, but a dealer must at all times make it clear to his customer that he is acting as a dealer or principal, if that is the fact."* This is also from The Bulletin, published by the National Association of Securities Dealers, on June 22, 1940.

RIABiz: So you were either a broker or a dealer, and back then you disclosed carefully what your relationship was?

RR: Yes, and the same holds true today. And the same was true back then for the distinction between a broker and an investment adviser. Under no circumstances were brokers permitted to use terms or titles that denoted a relationship of trust and confidence.

RIABiz: But that doesn't appear to be the case now. Registered representatives frequently refer to themselves as "financial advisors" and "financial consultants." Many use titles such as "Certified Financial Planner" or a host of other designations implying that a relationship based on trust might exist. What changed?

RR: I think the broker-dealer industry was again largely to blame. Let's contrast other statements made by the SEC in 1940 and 1963 to a more recent position taken by NASD, now FINRA, in 2005.

In its 1940 Annual Report, the SEC stated: *"If the transaction is in reality an arm's-length transaction between the securities house and its customer, then the securities house is not subject to a fiduciary duty. However, the necessity for a transaction to be really at arms-length in order to escape fiduciary obligations has been well stated by the United States Court of Appeals for the District of Columbia in a recently decided case: '[T]he old line should be held fast which marks off the obligation of confidence and conscience from the temptation induced by self-interest. He who would deal t arm's length must stand at arm's length. And he must do so openly as an adversary, not disguised as confidant and protector. He cannot commingle his trusteeship with merchandizing on his own account. ..."* This is from the Seventh Annual Report of the Securities and Exchange Commission, which was issued in 1941.

Later, in its comprehensive 1963 Report on the securities industry, the SEC stated that it *"has held that where a relationship of trust and confidence has been developed between a broker-dealer and his customer so that the customer relies on his advice, a fiduciary relationship exists, imposing a particular duty to act in the customer's best interests and to disclose any interest the broker-dealer may have in transactions he effects for his customer … [broker-dealer advertising] may create an atmosphere of trust and confidence, encouraging full reliance on broker-dealers and their registered representatives as professional advisers in situations where such reliance is not merited, and obscuring the merchandising aspects of the retail securities business … Where the relationship between the customer and broker is such that the former relies in whole or in part on the*

advice and recommendations of the latter, the salesman is, in effect, an investment adviser, and some of the aspects of a fiduciary relationship arise between the parties."

In other words, broker-dealers and registered representatives should not hold themselves out in any manner in which they would be perceived to be trusted advisors. If they do so, they should be considered as fiduciaries under the law. We have to contrast what the SEC said in 1941 and 1963 with the position taken by the SEC in the ill-fated Merrill Lynch Rule SEC Release. In 2005 the SEC stated: *"We have decided not to include in rule 202(a)(11)-1 any other limitations on how a broker-dealer may hold itself out or titles it may employ without complying with the Advisers Act."* This position by the SEC followed extensive lobbying by large broker-dealer firms and insurance companies on this specific issue.

What amazes me is how opposite the SEC's view in 2005 is from what the SEC stated back in 1941. Back then, registered representatives were not permitted to use titles which denoted anything but an arm's-length relationship. Today registered representatives use such titles, to the dismay of many.

The issue is not whether the Advisers Act applies; rather, it is whether fiduciary status attaches when such titles are utilized. Fiduciary status attaches not because of the application of the Advisers Act, but because the broker holds out as being a trusted advisor. See: *Why a swing-and-miss on fiduciary standards will haunt us for decades.*

Moreover, I'm reminded constantly of a quote from a paper written in 2010 by Professors James Angel and Douglas M. McCabe: *"To give biased advice with the aura of advice in the customer's best interest is fraud."*

A matter of trust

RIABiz: But doesn't the client's account opening documents provide if it is a brokerage account, as opposed to an investment advisory account? Doesn't this put the investor on notice as to what type of account it is?

RR: Good question. But again NASD expressed a view on this in the early 1940's. "*The name which the parties give the relationship is not determinative."* This is from the N.A.S.D. News, published on Oct. 1, 1941.

The NASD's early view of this is also reflected in many judicial opinions. Under state common law, fiduciary status attaches when a relationship of trust and confidence exists. What actually occurs between the parties is what is determinative. Any agreement between the parties which purports to define a fiduciary relationship as a nonfiduciary engagement is largely ignored by the court.

Think about it. If the rule were different, all clients could be asked to waive the fiduciary obligations of their advisors, simply by signing a form, even though an advisory relationship existed. Simply put, broad fiduciary duties are not subject to such a broad disclaimer.

RIABiz: So, determining whether a registered representative is a fiduciary is a complicated affair.

RR: Again, all brokers are fiduciaries, to the extent of their agency. The difficulty is determining whether the broker is providing investment advice. If investment advice is provided, then that advice is subject to the fiduciary standard.

RIABiz: But what about recommending a portfolio of mutual funds to a customer?

RR: Since 1975 several major developments have occurred in the brokerage community. The first is the demise of fixed commissions. The second is the rise of a great many pooled investment vehicles. Third was the growing importance of Modern Portfolio Theory. And fourth was the fact that compensation for selling products became more variable — some products have higher commissions and other fees than others. See: Why the Yale endowment model may still be fundamentally flawed.

Now, if the broker is defining an investment strategy for a client, rather than just providing a description of the product, then fiduciary status likely attaches, and with it very broad fiduciary duties of due care, loyalty, and utmost good faith. Remember that it is a facts-and-circumstances analysis. The use of titles or designations which denote a relationship of trust and confidence can also influence the determination as to whether a fiduciary relationship exists. So, in constructing a portfolio of mutual funds, registered representatives should assume that they are fiduciaries under state common law, with all of the duties which follow from such status.

RIABiz: How are registered representatives, or their customers for that matter, going to be able to tell when the broker is a fiduciary, or not?

RR: I think that FINRA, when it was providing an explanation of the recently changed suitability rule, started to proceed back in the direction of declaring that all brokers are fiduciaries. But FINRA has a long way to go.

Of course, the Dodd-Frank Act permits the SEC to impose fiduciary status upon brokers. What's interesting about Dodd-Frank is that all brokers are already fiduciaries, to the extent of the scope of their agency. See: *FINRA and SIFMA win big for Wall Street with release of Senator Dodd's bill yesterday.*

Moreover, if brokers provide investment advice, again, very early on, even the NASD recognized that the broker was a fiduciary with respect to the advice which was provided. This is regardless of whether registration as an RIA was required. Somehow the SEC lost focus on this issue. It's not whether the securities professional is a registered representative or an investment adviser representative. It's not whether the account is a brokerage account or an investment advisory account. Fiduciary status clearly attaches under the Advisers Act. But it also attaches when investment advice is provided by registered representatives.

'Fee-based' fraudulent?

RIABiz: Since the Merrill Lynch Rule was overturned in 2007, we've seen a lot of brokers become fee-based advisors and become dually registered. Is that a good thing?

RR: It depends on what aspect of the change you are looking at. Generally, clients prefer to pay an advisory fee, such as a percentage of assets under management or a fixed annual retainer, rather than pay commissions. And conflicts of interest are reduced, but not eliminated, by fee-based compensation.

However, in late September 2007, the SEC proposed a rule, never finalized, which the broker-dealer firms have applied far too liberally. Essentially part of that rule stated that a dual registrant could be a fiduciary with respect to an investment advisory account, while not being a fiduciary for a brokerage account or an insurance sales transaction for the client, at the same time. This proposed rule ignores the fact that fiduciary status

attaches not to the account, but to the relationship between the parties. In other words, once the fiduciary hat is put on, it generally extends to all parts of the relationship, not just a portion.

Also, putting on a fiduciary hat is like gluing the hat to your skull. Taking off a fiduciary hat, and transforming to a nonfiduciary relationship, is not easily done under state common law. It's not impossible, but it is very difficult. I've often wondered what a dual registrant says when trying to switch from a fiduciary relationship to a nonfiduciary relationship. Imagine being frank with the client and saying, "I'm your trusted advisor now. I must act in your best interests. But I no longer want to be a fiduciary to you. I want to enter a relationship with you which is arms-length, where caveat emptor applies, where you must evaluate my recommendations yourself since we are no longer in a trusted relationship, and where you are solely responsible for due diligence on any investment products I recommend to you." See: *A conversation between a wirehouse advisor and a senior citizen who seeks trust.* When you think about it, very few clients would ever desire to leave fiduciary protections behind.

I also want to say, I don't like the term "fee-based" as it is utilized today. It is inherently fraudulent, when used to describe an advisor.

RIABiz: What's wrong with that?

RR: The term "fee-based" was originally applied, back in the 1990s, to describe a type of wrap account. After 2007 it became increasingly utilized in a different way, by use of the term "fee-based advisor." The term is inherently misleading. If the advisor is receiving commission-based compensation, or may receive same, then the proper term is "fee-and-commission based advisor." Through the omission of "commission" in the term, fraud occurs.

One hat

RIABiz: Are you saying that dual registration is a bad idea?

RR: Not necessarily. It may make sense to be a broker for one customer, such as for a customer who ladders individual, high-quality municipal bonds, where the customer desires no ongoing review of the bonds following purchase. It may make sense to have fee-based compensation for that client's remaining portfolio, which receives ongoing management. The difficulty comes not in mixing the compensation, but in having registered representatives believe that the municipal bond purchases are not in a fiduciary capacity. Even if the broker-dealer firm sold the bonds as a principal, in this example the broker-dealer firm should regard itself as a fiduciary, with all of the disclosures and other legal obligations which follow. Again, fiduciary status extends, under state common law, to the entirety of the relationship.

There's an old adage, from an eloquent Tennessee jurist writing just before the Civil War. This judge stated that the fiduciary doctrine *"has its foundation, not so much in the commission of actual fraud, but in that profound knowledge of the human heart which dictated that hallowed petition, 'Lead us not into temptation, but deliver us from evil,' and that caused the announcement of the infallible truth, that 'a man cannot serve two masters.'"*

I don't think it is possible to "switch hats" from a fiduciary to nonfiduciary one, or wear two hats at the same time, for the same client. The temptation to not act in the client's best interest is too great. Moreover, the

client will never understand the dramatic shift which occurs when the fiduciary hat is removed; if the client did understand it, he or she wouldn't allow it.

Dodd-Frank moot?

RIABiz: Where does the Dodd-Frank Act stand now, as to the SEC's possible imposition of fiduciary status upon broker-dealers?

RR: By all accounts fiduciary rule-making is stalled at the SEC, and not likely to see action for at least a year, and possibly more. Perhaps this is a good thing.

RIABiz: Why?

RR: Well, to be quite frank, I don't think enough research has been presented to the SEC which describes the existing fiduciary obligations of brokers, as well as how brokers' fiduciary obligations were viewed back in 1940 — and even before then.

Remember that the Dodd Frank Act authorizes the SEC to apply fiduciary duties to brokers who provide personalized investment advice. Yet, fiduciary duties have always existed in such circumstances. Realizing this seems to make the Dodd Frank Act superfluous. Then again, perhaps the Dodd Frank legislation is just stating: *"Return to the way it was back in 1940, before NASD and FINRA rule-making activities somewhat lowered the standard of conduct of brokers who provide investment advice."*

In other words, I think academics, and the investment adviser community, have a lot of work to do. This includes more and better research on the fiduciary standard. When was it applied early in the 20th century, versus now? Why did FINRA adopt the much lower suitability standard, and does that standard make sense when there are so many more complex securities in existence today and investment advice is routinely provided by brokers? To what extent can the scope of the engagement be limited by a fiduciary? These are important issues which require more research.

Another issue has to do with disclaimers. I see statements in large brokerage firms' Form ADV, Part 2A, all the time, purporting to state that the firm is not responsible for any tax consequences resulting from the investment advice provided. That's just wrong. Minimizing the tax drag on investment returns is such an integral part of the investment advisory process, and is so significant for the consumer, that I seriously doubt that such a broad disclaimer is appropriate and legally effective. Recently other disclaimers of broad fiduciary duties have appeared, and these should be challenged, as well. Fiduciaries are not permitted to simply abrogate their core responsibilities by using disclaimers.

RIABiz: Why is the fiduciary standard so complicated?

RR: Well, it is complicated, and deservedly so for several reasons.

First off, there is not *"one fiduciary standard of conduct"* in all areas of the law. The fiduciary standard adjusts, in its requirements, to meet the circumstances of the parties, or the requirements of statutory law.

For example, the fiduciary duty is very strictly applied to trustees. The Employee Retirement Income Security Act of 1974 also applies the fiduciary standard as a tough "sole interests" standard. Attorneys have the fiduciary standard strictly, as well, although some specific rules relax application of the sole-interests fiduciary standard for attorneys in just a few contexts.

By contrast, employees are agents of their employers, and as such employees possess fiduciary duties as well. But given the greater power and knowledge of the employer, the fiduciary standard need not be so strictly applied.

Also, in the context of partnerships, and directors and officers of corporations, the fiduciary standard is applied more moderately. For example, the business judgment rule offers some safeguards against a strict application of the fiduciary standard of care against corporate directors.

So, in essence, the fiduciary standard is not a single standard, but rather the standard adjusts to fit the needs of the entrustor, or client, across a continuum. The greater the knowledge or power of the fiduciary, relative to the knowledge or control by the client, the more strictly the fiduciary standard is applied.

Fiduciary law has several foundational sources. Much of the strict application of fiduciary standard is found in trust law. Some of the looser application of fiduciary standards can be found in agency law, and other applications can be found in tort law. How that mix occurs for a particular type of fiduciary is always a subject of debate.

Where do those who provide investment advice stand? Well, at least outside of when ERISA applied, somewhere in between. The Investment Advisers Act's fiduciary standard is a *"best interests"* standard of conduct, not the sole-interests standard found in ERISA. Still, for investment advice the fiduciary standard falls much closer to the fiduciary standard existing under ERISA, and appears very similar to the standard applied for other professionals who possess much greater knowledge than the client and who provide advice to the client, such as attorneys. See: *NAPFA's John responds to critic questioning her group's stance on compensation in light of new DOL rules.*

RIABiz: Does this mean that conflicts of interest are permitted for those providing investment advice, at least when ERISA does not apply?

RR: Most of the time, under the *"best interests"* standard, but safeguards still exist.

Now, the Wall Street firms espouse the view that disclosure solves the problem when a fiduciary possesses a conflict of interest. This may be sometimes true in one form of agency relationship, such as an employer-employee relationship, where the entrustor (the employer) generally has superior knowledge and power.

Feeling the burn

But disclosures are not so effective in an advisory-type fiduciary relationship, where there is a vast disparity in the knowledge and acumen of the parties. This is what occurs when investment or financial advice is provided to a client. In such circumstances, a variety of behavioral biases exist which undermine the ability of the client to obtain, pay attention to, and understand any disclosures. There is plenty of academic research that

demonstrates the inherent limits of disclosures in the circumstance of an advisory relationship on complex matters. Robert Prentice wrote a great article about this, published in the Duke Law Journal in 2004.

Also, more recent research, such as that done by Daylian Cain, a Yale University professor, illustrates that disclosures can actually lead to worse advice. In other words, as he states, sunlight is not always the best disinfectant. By making a disclosure the fiduciary feels *"liberated"* by the fact of disclosure, and the advice actually becomes, on average, worse.

Here's the key point: If disclosures worked, there would be no need for the fiduciary standard as applied under the Advisers Act, or under ERISA, for that matter. But we have a great deal of academic research demonstrating that disclosures, while important, don't solve the huge knowledge gap between individual investors and securities professionals. See*: Why the DOL's massive new 401(k) disclosure requirements are a 'very, very big deal'.*

What the best-interests standard of conduct requires, under the Advisers Act, is that even with disclosure of a conflict of interest, certain other safeguards must be observed. First, the disclosure must be detailed in every respect — complete candor is required. Second, the disclosure must be presented in a format which is understandable to the client; if the client is elderly or unsophisticated, greater disclosure (or time spent explaining the disclosure) is required. The duty is on the advisor to ensure client understanding. Third, the informed consent of the client must be affirmatively obtained by the advisor. And courts refuse to believe that a client would ever consent to harm, such as by giving up a portion of investment returns in order that the advisor can receive additional compensation. Clients don't make such gratuitous transfers.

Lastly, there may be some conflicts of interest that are so egregious that a fiduciary investment or financial advisor must avoid the conflict of interest. And if multiple conflicts of interest exist, the fiduciary relationship with the client might be so undermined that the advisor will lose the client's trust, anyway. See: *Report of a possible delay in DOL's fee disclosure rule sparks apprehension among advisors and industry observers.*

12(b)-1 fees anti-competitive

RIABiz: Aside from the SRO issue, and the fiduciary standard's application, what other public-policy issues interest you at present?

RR: I have a lot of interest in mutual fund regulation and disclosures. I have long been perplexed by some of the practices which the SEC permits to occur within investment companies, such as mutual funds.

For example, many mutual funds and ETFs share perhaps half, or some other significant amount, of securities-lending revenue with the fund's investment adviser. I view the securities-lending revenue as an asset of the fund, and its shareholders. If the investment adviser wants additional compensation for managing the securities-lending process, it should show up as part of the advisory fee. Recently European regulators began to address this. I hope the SEC's Division of Investment Management follows suit.

RIABiz: You've written about 12(b)-1 fees in the past.

RR: I am disappointed by the SEC's lack of progress on this issue, and I'm perplexed by the very nature of 12(b)-1 fees. They make no sense. See: *Why FINRA's power grab for RIAs needs to be stopped to avert the death of the profession, Part 1.*

Think about it: a customer is sold a Class C mutual fund share by a broker, which pays a 1% annual 12(b)-1 "marketing fee," usually for as long as the customer owns the fund. But the broker does not ordinarily have any duty to monitor that investment or the investment portfolio. So the 12(b)-1 fee, most of which the fund passed on to the brokerage firm, could get paid for 10, 15 or more years. This amounts to unreasonable compensation, in my view. This problem is as big as the scandal about 10 years ago involving the sale of Class B shares. See: *A cap on 12b(1) fees is going to have one predictable result. Think carnival games*.

If, however, the broker provides oversight of the pooled investment vehicles for the client — and this also applies to variable annuity subaccounts — then the advisor is providing investment advisory services. In this case, the 12(b)-1 fee looks more and more like *"special compensation"* and the Advisers Act's many requirements should attach. Regardless, state common-law fiduciary standards would seem to apply in such instance.

Also, 12(b)-1 fees are anti-competitive. In most instances when a percentage-based fee is applied, such as by an investment adviser, the client can negotiate the fee. Perhaps it is a lower-AUM fee for a larger portfolio. Perhaps it is a lower AUM fee, just due to competition in that particular geographic market. But 12(b)-1 fees cannot typically be negotiated in personal brokerage accounts. Hence, I'm surprised that an anti-trust investigation has never occurred of 12(b)-1 fees. Even without such an investigation, or if the Sherman Act is inapplicable for any reason or is not violated, 12(b)-1 fees are still anti-competitive in nature, and should be banned for that reason alone.

Regarding mutual funds, I'm also concerned about the extent of trading costs, whether they be explicit commissions, or costs resulting from bid-ask spreads or market impact. These transaction costs can be so large that they can dwarf a mutual fund's annual expense ratio. See: *A few words with John Bunch as he steps into the CEO spot at The Mutual Fund Store.*

I'm concerned that advisors who undertake due diligence don't fully appreciate these hidden costs. This is especially so since the amount of trading is often underestimated in the published *"turnover ratio."* The SEC permits funds to publish the lower of sales or purchases, rather than use the average of sales and purchases, when determining turnover ratio. This can result in a much lower reported portfolio turnover ratio, than the actual portfolio turnover ratio, especially when large cash inflows or outflows occur during the period.

Regardless of the cause of trading, the SEC needs to recognize that an accurate portfolio turnover rate is increasingly an important source of information for both advisors and clients. The current reporting method for the portfolio turnover rate is misleading and hence flawed.

I'm also concerned that there seems to be a very high causal relationship between where brokerage dollars go, and the broker-dealer's sales commissions. Directed brokerage seems alive and well for many funds and brokerage firms, and this could likely be demonstrated by a statistical analysis. I hope someone pursues this as a research project.

I also would love to see Congress repeal soft-dollar compensation. And why doesn't the SEC, in the interim, require brokerage commissions to be estimated as a percentage of the fund's net asset value, and have that percentage number clearly set forth immediately below the annual expense ratio in both the summary prospectus and statutory prospectus. Whether soft-dollar payments are made should also be clearly stated, and perhaps a disclosure, in percentage terms, of the impact of soft-dollar compensation.

All of this should be added up, for the client to see. In essence, we need a new "total expense ratio" for funds, rather than the "annual expense ratio" which is disclosed today, which can be quite misleading in many instances.

A true profession

RIABiz: You've written in the past about the mutual fund practice of *"payment for shelf space."* Why is that such a bad practice, when it doesn't impact the annual expense ratio? See: *One-Man Think Tank: The fiduciary standard may sink Wall Street's advisors-on-yachts. Should we care?*

RR: Payment for shelf space is an insidious practice that should be banned for all time. Again, brokers are fiduciaries, and as fiduciaries they should seek to avoid, not embrace, conflicts of interest. If they are recommending an investment product to their client, they should seek to do so under a levelized compensation approach. Since payment for shelf space results in variable compensation to the broker, it is a conflict of interest which really prevents brokers, and their registered representatives, from adhering to their fiduciary obligations.

RIABiz: You've written extensively about the *"profession"* of investment advice and about financial planners. Are you seeing progress being made there? See: *Part One: Investment Advisers: Is our path toward, or away, from a true profession?*

RR: There is a lot of desire, by the leaders of the financial planning community, to move toward a true profession for financial planners. But, quite frankly, I think we need to keep FINRA from overseeing investment advisers first before tackling the fiduciary rule-making at the SEC.

There's a lot to making a true profession. Including more defined fiduciary standards of conduct. I've proposed for a few years some standards of conduct I would like to see adopted by the professional organizations, for the members. If we want to become a true profession, we need to move the ball forward. More-defined fiduciary standards of conduct can be utilized to educate and inform professionals, and help them stay out of trouble.

RIABiz: How can the ball be moved forward?

RR: I would love to see the day where everyone who calls themselves a financial planner is a true professional and I would be proud to have them as a professional colleague. We are a long way from that day. If financial planning, and the provision of investment advice, is going to arise to the level of a true profession, then individuals must let their leaders know such is their desire. They need to approach their leaders at conferences and meetings. They need to write to their associations' boards of directors or other leadership. Only by letting it be known that we want a true profession will we ever have a chance of attaining such.

RIABiz: What about the influence of the CFP Board?

RR: In many respects the Certified Financial Planner Board of Standards Inc. has successfully evolved and is leading the way toward a true profession for financial planning. See: *CFP Board makes a raft of changes — including plans to send out press releases about CFP members who declare bankruptcy.*

Yet I'm still disturbed by some of the Standards of Professional Conduct the CFP Board possesses, or at least how they are interpreted. For example, look at the requirement that two planning areas must be impacted before fiduciary duties are applied. Can anyone really believe that *"retirement planning"* is not an advisory activity, and hence fiduciary status should not attach? It seems to me that, regardless of how the CFP Board might view it, most *"retirement plans"* are done in an advisory, trusted relationship, and fiduciary status applies under state common law, regardless of licensure or certification.

I also would like to see the Standards of Professional Conduct revised, to more clearly spell out the specific fiduciary obligations which exist, for the purpose of educating CFP certificants. The CFP Board's fiduciary standard should be more closely aligned with the state common-law fiduciary standards applicable to the delivery of financial and investment advice.

RIABiz: Recently you've been writing more about due diligence, with respect to both investment strategies and investment products. Why so?

RR: I think some incredible progress has been made in identifying due-diligence processes, such as by fi360 LLC and other organizations. But I'm concerned that due diligence, whether for overall portfolio investment strategy, or as to specific products, remains in its infancy, in terms of its development. I hope to explore, and write about this, a great deal more in the years ahead. See: *The ABCs of doing due diligence on fixed income annuities.*

Looking forward

RIABIz: Now that you've declined to lead NAPFA, you've announced that you will be cutting back your advocacy efforts in favor of more research and education of advisors.

RR: Back in 2008 I announced my desire to focus more on research and education. Then the financial crisis occurred, and with it the prospect of major financial services legislation. So, I re-entered the public policy area. I've always wanted to focus more on education, rather than advocacy. About a year ago I accepted the position as chairman of the financial planning program at Alfred State College in New York. I'd like to focus more on research and education, not only of my students but also of financial planners, in the years ahead. Others can pursue advocacy on public-policy issues.

RIABIz: How is your teaching going?

RR: It has been a great first year, and I look forward to many more. I feel I've been able to make a real impact on the futures of many, many students. I believe I've been able to substantially influence students to become better, in many aspects of their lives.

In fact, I've written a workbook, titled *"My Success Journal,"* for college and high school students, which teaches them what I call *"The Three 'S's' in Success."* The exercises contained in this workbook are drawn from my experiences in my first year of teaching, and the great feedback I've received from my students.

'Target on my back'

RIABIz: Discuss your compliance violation and why you stepped down from NAPFA?

RR: Recently I discerned that I had registered several months late, as a state-registered adviser, not in my home state but in another state where I exceeded the de minimis requirements. While the late registration was due to an unintentional error on my part, late registration as an RIA in any jurisdiction is a serious matter. At this point I am well on my way to resolving for myself, personally, the ramifications of this mistake.

However, the impact of this mistake could be felt by the several industry organizations with which I am involved, and it is my desire to minimize any impact upon these fine organizations. I've been very vocal about my feelings about FINRA, during the recent debate about the Bachus bill. In other words, I've put a big target on my back.

Simply put, I don't want to provide the opportunity for my opponents to attempt to use my compliance mistake as a means of attacking or undermining the credibility of the organizations with which I may be associated. Hence, it just seems that the right thing to do is to resign from the leadership positions of these several industry organizations.

While my opponents on these regulatory issues may still attempt to use my personal mistake to attack these organizations, I hope that your readers will see that such a tactic is just a diversionary tactic, and nothing more, from addressing the real issues in a constructive fashion.

Greater good?

RIABiz: There's a strong sense among people that the drawbacks of keeping you on may be outweighed by the good that you are able to do. What do you say to those people?

RR: You just have to look at the Mark Spangler situation with NAPFA. When Bachus made his statements at the beginning, he made a point of singling him out. There's a saying: If you can't attack the message, attack the messenger. I didn't want to give [fiduciary opponents] the ammunition. I got two rules mixed up in my head, but [filing late with the state of Florida] is a serious matter. It's treated as if you're a completely unregistered advisor. See: *Tamarac CEO: Mark Spangler's big trouble with the feds won't harm Tamarac.*

RIABiz: So you're certain you made the right call?

RR: It wasn't even a close call. And NAPFA did the right thing in accepting my resignation. There will be people who can run this organization well without this distraction.

RIABiz: Does this mean you will cease all advocacy on issues confronting the investment advisory and financial planning professions?

RR: Publicly, yes, at least for a time. But I will continue to research and write, and feed the results of my efforts to the many capable organizations and their leaders who are already engaged in advocacy efforts. I will likely cease public commentary myself, except if I choose to submit comment letters directly to regulatory agencies.

I was very disappointed in myself, for making such a careless error. The impact upon me, and my practice, is minimal. With my focus now on teaching, I'm not seeking to grow my practice, and I don't anticipate losing any clients as a result of this compliance mistake. While the public disclosure of this mistake will likely result in some public commentary, primarily by those who oppose my views on public policy issues, I can take the heat. I've had some sleepless nights, but those are behind me now, as I move on.

I am much more concerned, however, that the organizations I have worked with in the past not be harmed, as I knew would occur if I continued to be in a leadership or advocacy role with such associations. Hence, limiting my role in those organizations seems the prudent thing to do. If I were to continue to advocate, the focus would likely be put on the messenger, not the message of these organizations, which is so important.

Emergency descent

I'd like to put this in context, as well. About 12 years ago I was flying back and forth from Orlando to Newark, each and every week, while doing some consulting work for a major financial services firm. One evening, after my plane took off from Orlando and was approaching 35,000 feet, the unmistakable smell of an electrical fire filled the cabin. Smoke also started to appear in the cabin, and several of the passengers had to go on oxygen as a result.

The pilot made an emergency descent, extremely fast and with a lot of banking, and landed at the Jacksonville airport. The plane was quickly surrounded on the runway by about 30 fire trucks. After landing, the pilot shut down all the systems, and the electrical fire, wherever it was, seemed to stop. The plane was towed to the terminal and we were finally allowed to deplane, about 45 minutes after the electrical fire and resulting smoke first were noticed.

There have not been many times in my life when I have been that fearful. I knew that a fire on an airplane was a potential disaster. So, what did I think about when faced with a potential life-threatening event? Not my work. Not regulatory issues. All of my thoughts were about my family and close friends.

So let's put things in perspective. Yes, I made a mistake. While the mistake was unintentional, the fact of late registration remains serious, and I don't want to belittle the violation in any way.

But, in the scheme of life, there are much more important things to me — my family and friends. I'm blessed to have a loving wife, two great daughters, and a host of friends and professional colleagues that I enjoy associating with.

Mentioned in this article:

National Association of Personal Finance Advisors Association

Top Executive: Ellen Turf