The Navigator

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Pekin Hardy Strauss Wealth Management

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To achieve their financial goals, clients must be able to trust their financial advisors. Unfortunately, the financial advice industry is rife with conflicting interests, misguided incentives, and confusing terminology. Financial advisors who are not held to a "fiduciary standard" may not act with their clients' best interests in mind; indeed it is our view that advisors not held to a fiduciary standard may act in ways that harm the financial health of their clients. To the detriment of diligent investors who are trying hard to save and invest for retirement, many financial advisors in the United States are not held to a fiduciary standard in many of their dealings with clients. In this Navigator, we take a close look at the meaning of fiduciary duty, provide guidance for understanding who is and is not a fiduciary, and discuss current regulatory efforts to extend the fiduciary standard across the financial industry. We also describe Pekin Hardy Strauss's responsibilities in our role as a fiduciary for our clients.

Who Can You Trust?

by Matthew Blume, CFA
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What is a fiduciary?

The word "fiduciary" is derived from the Latin word "fiducia," meaning "trust." Thus, it should come as no surprise that a "fiduciary" is someone in a position of trust who has a legal obligation or duty to act with care and loyalty and in the best interest of another party. Under U.S. laws and regulations, fiduciary duty is one of the highest standards of care owed to a client or potential client.

While fiduciary duty may exist in a number of different professional and personal situations, the term is most commonly invoked in the context of financial services because few areas of a person's life more strenuously call for such a standard of professional care than one's personal finances and investments.

In the financial services industry, there are several types of fiduciaries. While the specific requirements may vary, generally speaking, a fiduciary is a financial professional who is legally required to act prudently and *in the best interest of his or her clients or stakeholders*. A fiduciary *must always* consider the client's interests before his or her own interests and *may never* act in a way that violates this requirement, under penalty of law. The importance of this obligation cannot be overstated. Fiduciary duty binds a fiduciary to making decisions in the best interest of clients, even if the consequences of those decisions might be damaging to the fiduciary!

To better understand the idea of fiduciary duty and how it applies to investors, a bit of history may be instructive. For years, stockbrokers were the primary intermediary for most investors who wanted to transact in the financial markets. Stockbrokers were compensated by commission, and they were very much not fiduciaries. Brokers earned commissions on every transaction that their clients executed and so had an incentive to recommend as many transactions as possible, regardless of whether such transactions were actually in the clients' best interests. This system was allowed by regulators because *brokers must only meet a suitability standard, a less stringent level of responsibility*. Brokers are salespeople, and their job is to sell.

Over time, the broker model has largely given way to the advisory model, in which financial professionals manage their clients' investments for a fee.[1] The primary benefit of the advisory model is that the incentives of the advisor and the client are more closely aligned. For example, while brokers previously had an incentive to conduct a high volume of transactions in order to generate commissions (known as "churning"), fee-based advisors have no such incentive. In the advisory model, trades are made on a client's behalf when

1 While advisors who operate under this model are not compensated through commissions on transactions, clients are typically still charged a small commission on transactions by the clearing broker-dealer.

such transactions are deemed to be in the best interest of the client. We believe this model creates a stronger incentive for advisors to focus on the long-term financial health of their clients, rather than to generate short term sales opportunities.

While the advisory model has gained substantial popularity and is now the dominant business model in the investment advising business, the broker model is far from dead. Unfortunately, there are many "financial advisors" who actually operate a hybrid business model. These advisors charge a fee for ongoing investment advice and portfolio management, but they may also sell certain types of products to their clients that generate substantial sales commissions. For example, these hybrid advisors may sell their clients various types of insurance products (whole life insurance, variable annuities, etc.) or non-traded alternative investments that can result in sales commissions of more than 10%.[2] While it is entirely legal for advisors to sell such products to their clients, these financial products primarily serve to enrich advisors while potentially harming clients. Advisors or brokers who sell insurance products earn substantial commissions on such sales, creating strong incentives to peddle products to their clients that may or may not be necessary. Furthermore, because the fiduciary standard does not apply to these relationships, conflicts of interest relating to the commissions earned on product sales are rarely disclosed.

At issue here is the fact that not all "advisors" are equal in the eyes of current law. There is more than one type of legal registration that allows individuals to provide financial advice in the United States. These different registrations carry different standards of care that must be applied in dealings with clients.

- ***Investment Advisor***
  According to the Investment Advisors Act of 1940, an investment advisor is "any person who, for compensation, engages in the business of advising others, either directly or indirectly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities." Investment advisors are subject to the highest standard of care and loyalty, or, in other words, the **fiduciary standard**. Investment advisors provide ongoing, primarily fee-based, investment advice to their clients and typically have discretionary authority over the management of client accounts.[3] Investment advisors are typically registered with the Securities and Exchange Commission (SEC) or with the state in which they operate as a Registered Investment Advisor (RIA).

- ***Broker***
  As briefly described above, brokers are financial intermediaries who are compensated by commissions on product sales and other transactions. Brokers, often called "registered representatives," are not subject to the fiduciary standard but rather a lower standard known as the **suitability standard**. The vast majority of financial advisors working for large Wall Street firms and wire houses fall under this definition. Brokers avoid the fiduciary standard by way of an exemption in the Investment Advisors Act of 1940 which states that individuals whose advice is merely incidental to the sale of products and who receive no "special compensation" are not required to register as investment advisers. Brokers are required to deal fairly with their clients and adhere to the lower standard of suitability; they are *not* required to put the interests of their clients ahead of their own. Brokers are primarily regulated by the Financial Industry Regulatory Authority (FINRA).

- ***Dual Registration***
  According to a FINRA study, approximately 88% of investment advisors are also registered as brokers.[4] Dual registered advisors have the ability to manage discretionary, fee-based accounts and, at the same time, earn commissions from the sale of various investment products. The key issue for clients to understand is that dual registrants may be held to different standards of care for different accounts owned by the same client. A dual registrant may manage a fee-based advisory account for a client on which the advisor is required to act as a fiduciary, while at the same time recommending commission-based products to the same client in a brokerage account on which the advisor is only held to the suitability standard.

What does fiduciary duty entail?

As stated previously, advisors who are subject to the fiduciary

2 Non-traded alternative investments are securities that do not fall within the categories of traditional stocks, bonds, or cash and for which there is no active secondary market. Common examples of securities that fall within this asset class are non-traded real estate investment trusts (REITs) and non-traded business development companies (BDCs). Non-traded alternative investments tend to be illiquid and are not marked-to-market on a daily basis.

3 While investment advisors typically earn the majority of their revenues through ongoing management fees, many also earn commissions on the sale of certain types of investment products

4 FINRA November 2nd, 2010 letter to the SEC Secretary, Elizabeth Murphy; https://www.finra.org/sites/default/files/Industry/p122404.pdf

standard must always act in the best interests of their clients. But what does this really mean in practical terms, and how is it different from the suitability standard? Some of the biggest differences between the fiduciary standard and the suitability standard lie in the duty of loyalty and disclosure of conflicts of interest, including the disclosure of fees and commissions. It is entirely possible for a particular investment product to be "suitable" for a client on technical grounds yet not be in the client's best interest. The commission structures of many products create strong incentives for advisors and brokers to push them on clients, even though such products may not be the best way to meet clients' investment needs.

Under the suitability doctrine, an advisor will have met his or her standard of care simply by confirming that the product aligns with the risk profile of the client, regardless of the conflicts of interest that may exist with respect to commissions and other incentives. However, under the fiduciary standard, in addition to determining that the product is in the client's best interest (versus merely "suitable"), an advisor is required to fully disclose any commissions or fees that he or she stands to earn on the sale of the product. The fiduciary standard raises the bar of prudence with which the advisor must make investment decisions on behalf of clients. Instead of considering a set of suitable investments and picking the one that benefits the advisor the most, the fiduciary standard requires that the advisor select the one that most benefits *the client*, regardless of its impact on the advisor.

Regulatory changes coming?

As a follow-on to the Dodd-Frank Act, which sought to impose greater regulatory oversight of the financial industry in the aftermath of the Financial Crisis, the U.S. Department of Labor (DOL) laid out a new set of rules that will extend the fiduciary standard to a number of financial professionals who were not previously subject to it. The DOL's ruling, which was originally scheduled to take effect on April 10, 2017 but which was postponed until June 9, elevates any financial professional who works with retirement accounts or who provides retirement planning services to the level of a fiduciary with respect to such accounts and activities. Brokers, insurance salespeople, and dual registrant advisors who work with IRAs, 401(k) plans, or other retirement-related accounts may not rely on the suitability doctrine.

Due to the potentially negative impact on their respective commission-centric businesses, the DOL's fiduciary rule has been met with a significant amount of criticism from Wall Street firms, wire houses, and insurance companies, and even some registered investment advisors. The changes imposed would likely make it more difficult for these companies to sell certain types of investment products, materially hampering their profits in turn. It seems unlikely that these firms would have the same level of success in offloading high-commission, high-fee Wall Street concoctions onto clients when the law dictates the advisor must act in the best interest of the client. It should be noted that the DOL fiduciary rule was a regulation promulgated by the Obama administration, and the Trump administration has made statements that appear to indicate they want to reduce the burden of regulation on the financial services industry. It remains unclear at this point how the DOL will ultimately implement the rule.

Where Does Pekin Hardy Stand?

Pekin Hardy Strauss Wealth Management is registered with the SEC as a Registered Investment Advisor (RIA), and as such, adheres to the fiduciary standard. We are required by law to exercise the highest level of care, prudence, and loyalty in our dealings with our clients. We operate entirely on a fee-based advisory model and must act in the best interest of our clients. We are intentionally not insurance licensed and cannot sell insurance products, though we do advise clients on insurance-related issues. Indeed, in previous Navigators we have discussed in detail our views of a wide range of insurance products, from annuities to long-term care insurance to disability insurance. In all cases, our opinions on insurance matters are solely based on what is in the best financial interests of our clients.

The DOL fiduciary rule has wide-ranging implications across the financial services industry. However, the impact that this rule, if instituted, would have on our business and our client relationships will likely not be significant because we are already a fee-based investment advisory firm with fiduciary responsibility for our clients' assets.

In closing, clients should note that our goal is to provide the highest level of service to our clients with transparency and aligned incentives. Beyond the legal standard, Pekin Hardy believes that the fiduciary standard is one to which advisors should willingly adhere. We are proud of our status as fiduciaries, and our greatest asset is the trust that our clients place in us as investment advisors.