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The Fiduciary Role: Clearing the Air

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The Fiduciary Role: Clearing the Air

While public trust of "Wall Street" has suffered a steady decline over the past two decades, it has been in a virtual freefall since the financial meltdown of 2008. This confidence crisis is not new, however, as public perceptions about investment markets and investment banks have been fluctuating for more than two hundred years. Individual investors in particular have long felt that Wall Street brokerage firms and investment bankers were acting principally in their own interest, often putting the needs and well-being of their clients second. In the wake of the 2008 economic and market meltdown, a high percentage of individual investors have been asking themselves, and rightfully so, "Where can I find a trustworthy source of investment advice?"

The good news is that a trustworthy source of investment advice does exist, and it is not limited to the super-wealthy. This source is the fiduciary investment advisor and fiduciary wealth manager.

On the following pages, we will delineate and explain the differences (and practical implications) between two types of financial advisors: 1) a registered representative of a Wall Street brokerage firm (herein referred to as "brokers"), and 2) an independent investment advisor or wealth manager acting in a fiduciary capacity (herein referred to as "fiduciary advisors"). First, we will provide a brief explanation of the legal standard of care, which currently applies to these two types of financial advisors. A brief overview of the history and evolution of efforts to set standards of care for those rendering investment assistance to clients is provided as additional background. This is followed by a discussion that contrasts the roles and compensation methods of registered representatives versus investment advisors. Finally, we illuminate the conflicts of interest faced by investment professionals functioning in each of these roles.

Basic Definitions and Evolution of Standards of Care

As representatives of a brokerage firm, brokers provide financial services to their clients, which may include advice or suggestions regarding investing. In this capacity, brokers are held to a legal standard called suitability. Suitability is a basic standard that requires brokers to recommend investments that are deemed "suitable" for the client, regardless of whether these investments are lucrative to the broker at the client's expense, or whether superior alternatives are readily available.

Fiduciary advisors are engaged directly by clients to provide advice regarding investments and related financial matters. Fiduciary advisors are held to a legal standard of fiduciary duty in rendering service to advisory clients. Since 1940 when Congress passed the Investment Advisers Act1, it has been clear that investment advisors (those who are compensated for advising others on investing) are required to put their clients' interests ahead of their own. This is the essence of fiduciary duty. Thus, a fiduciary advisor must strive to choose the investment that best serves the client, though some alternative choice that might not be as attractive would offer some special benefit or compensation to the investment advisor.

A History of Brokerage and Fiduciary Standards

The first brokerage system was created in 11th century France as a way to facilitate banks trading agricultural debts.2 Local banks were beginning to make loans to farmers to help them expand their crop yield and provide them needed funds during the non-harvest months. This quickly grew into a problem for the local banks as all of their loans were concentrated in a small geographical region. When bad weather or crop disease struck, it affected the entire area, not just one farm, and the bank would often go under. Brokers began to provide a vital service by allowing banks in different areas to trade loans enabling the banks to geographically diversify the areas in which they were lending. These brokers were individuals and did not invest their own capital, but rather merely matched buyers and sellers.

Hundreds of years later in the 1600's, the earliest true brokerage firms began to operate out of coffee houses in major cities such as London, Philadelphia, Amsterdam and New Amsterdam (New York City). These firms allowed individuals to purchase commodities and securities from multiple sources rather than be forced to rely on a single broker with no competition. Without such competition, brokers could charge outrageous fees for transactions because they were generally the only broker in the area. These casual gatherings in the coffee houses of London and other emerging financial centers around the world allowed the securities firms themselves to trade securities and commodities among one another.

Frequently, fevered "discussions" and "spirited debate" would take place in these coffee houses among the various brokerage firms, and it was not uncommon for trading to come to an early close for the day as a small riot.

By the end of the 1600's, London and major cities in continental Europe began to recognize numerous instances of "market rigging", insider trading and outright fraud perpetrated by these brokerage firms and the companies whose stock they traded. In 1698, several brokerage firms were expelled from the English Royal Exchange for rowdy behavior. Around the same time, a first attempt at regulating broker behavior came about when an English law was passed to "restrain the number and ill-practice of brokers and stockjobbers". The law required all brokers to be licensed and to take an oath to act lawfully. Unfortunately, this was not a terribly high hurdle, and the so-called "ill practices" continued, albeit with growing complexity and little transparency.3

Approximately two decades later, in 1720, the speculative behavior culminated when the South Sea Company's bubble burst—one of the worst crises in world financial history.4 In one year, South Sea shares had increased from £100 to £1,000 before collapsing back down well below £100. In an attempt to shore up the stock price, South Sea began lending money to people so they could buy shares of its own stock, thus temporarily raising the stock price. The South Sea Company left in its wake a giant scandal, financial ruin for many, and a complete vacuum of accountability—a situation not unlike the recent sub-prime mortgage crisis.

In its prime, South Sea Company was viewed as the model of a publicly traded company. Other companies began adopting this model and began to trade their shares publically. Various schemes quickly developed. In one famous instance, a company successfully went public with a business plan that was quite simply, "a company for carrying out an undertaking of great advantage, but nobody is to know what it is".

In response, the English Court of Chancery developed a "Legal List" of securities that fiduciaries could recommend to investors. These lists were generally quite restricted, composed of sovereign government debt and first mortgages, with an occasional equity investment. They were considered very safe, though not terribly exciting.

English Court of Chancery Debating Legal Lists

The legal list concept carried over to America and was in place until 1830, when in the Harvard College v. Armory case, a Massachusetts court rejected it and instead called for a "Prudent Man" rule. In essence, the Prudent Man Rule called for fiduciary advisors to "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income and probable safety of the capital to be invested." This standard still called for an approach of selecting prudent investments on a one-by-one basis instead of considering whether a client's portfolio was prudent as a whole. Though it seems limited by today's standards, the Prudent Man rule opened up numerous types of investments that could be recommended or made by fiduciaries who were previously unavailable on the Legal List.

The Prudent Man Rule survived until the mid-1980's when it evolved further after expression of serious reservations concerning its limitations by scholars and sophisticated investors in favor of the Prudent Investor Rule. This newer evolution allowed fiduciary advisors to invest client portfolios by considering overall risk and return at the portfolio level, instead of applying the rule to each individual investment on a one-by-one basis. In essence, it allowed for the benefits of a fully diversified portfolio to be utilized by fiduciaries acting in their clients' best interest.

By 1994, almost all states had repealed the Prudent Man Rule in favor of the Uniform Prudent Investor Act, which embraced the Prudent Investor approach. The Prudent Investor approach recognizes the validity of Modern Portfolio Theory5 and the benefits of seeking total portfolio return at acceptable risk level (instead of individual security returns) when exercising fiduciary duty.

Today, the role of a fiduciary advisor remains to put the interests of their clients first and to invest their clients' portfolios with respect to overall risk/return and a total portfolio structure that has the best chance of achieving the client's goals.

Since 1940, it has been relatively well settled in the law that the fiduciary standard embodied in what has become the Prudent Investor rule applied to fiduciary advisors, while the lesser suitability standard applied to brokers. In reviewing the history of investment markets, it is clear that investors generally do not understand the difference between a fiduciary duty and a lower standard of suitability. This lack of understanding is evident in the often-publicized opinion surveys that ask "Who do you trust?" Stockbrokers, and particularly insurance brokers, consistently rank low in these surveys.

Beginning in the 1990's, however, the big brokerage firms began offering fee-based accounts to their customers as an alternative to commission arrangements. When the issue was raised as to whether these brokers needed to measure up to the same fiduciary standard as investment advisors, the SEC created a rule exempting brokerage firms from the tougher fiduciary standard. The "Merrill Rule" (named after Merrill Lynch, who sought the ruling), was struck down in 2007 by the United States Court of Appeals.6 The court ruled that brokers who provide an account with fee-based services must adhere to the same fiduciary standard. While that might have seemed to resolve the issue, it actually left many consumers in perhaps a more confused position.

Today, many stockbrokers and insurance brokers who offer fee-based services wear two interchangeable "hats". In discussing fee-based services with a client, the broker may put on their "investment advisor hat" by offering these services through the part of their firm that is a registered investment advisor. Because of the Appeals Court ruling, this particular advice must measure up to the fiduciary standard. However, in the same conversation or proposal, the broker may switch to the "broker hat" and begin offering products that only measure up to the lower suitability standard. As one might imagine, it can be difficult for the client to discern where their advisors' loyalties lie with respect to advice. The largest brokerage firms generally discourage their brokers from engaging in business that triggers the fiduciary standard of care due to the inherent increase in liability the firm could potentially face.

To clear up some of this confusion, we will explore the fundamental differences in roles and compensation between brokers and fiduciary advisors.

Securities Brokers: Roles and Compensation

In the simplest terms, a securities broker is a sales person whose job it is to carry out transactions for the client. In the investment industry, those transactions might be stock trades, bond trades, mutual fund trades, options trades, or derivative trades, among many others. Brokers often provide additional services incidental to trade execution. The broker must be licensed and must work under the supervision of a brokerage firm. Hence, under law, brokers are referred to as "registered representatives" of their firm, and the brokerage firms come in many shapes and sizes.

Brokerage firms can generally be divided into two categories: full service or discount. Examples of full service brokerage firms include Morgan Stanley Smith Barney, Merrill Lynch or Wells Fargo Advisors. Examples of discount brokerage firms include TD Ameritrade, E-Trade or Scottrade.

Securities brokerage firms hire registered representatives (brokers) to execute trades on their clients' behalf. In doing so, they act in an agency capacity meaning they are charged with obtaining a client's order completed at the best price in the fastest way possible.

Brokerage firms often provide some or all of the following services:

- Trade Execution
- Research
- Advice
- Insurance
- Margin Loans
- Online trading and account access – many now have PDA access
- Access to Initial Public Offerings (IPO's)

The securities broker plays a vital role within the financial services industry by providing an efficient manner of buying or selling securities, and by providing liquidity within the market where it might not exist otherwise. The broker provides these services subject to the legal standard of suitability, as discussed above.

Compensation of Brokers

One area that can prove difficult to understand is compensation from fees and commissions charged to clients by brokerage firms. Many individual investors feel these various fees are intentionally hidden in order to obscure their significance. Fees charged by brokerage firms come in many different forms.

Most people are familiar with the basic commission charged by a broker for executing a trade to purchase or sell an investment security. However, there are numerous other structures whereby brokerage firms and their registered representatives receive compensation, not all of which are readily apparent to the client. The following is a list of the types of commissions and fees often charged or collected by brokerage firms. Together, these represent the revenue that firms receive from brokerage activities (separate from investment banking activities which are discussed later). Typically, the firms share a percentage of these sources of revenue with their registered representatives (or brokers) who service the needs of the firm's clients. This shared percentage forms the broker's compensation for his or her work.

- Trade Commissions
- Mutual Fund Sales Charges (Loads)
  - Front End Load
  - Back End Load (with 12(b)-1 fees)
  - Level/Low Load (with 12(b)-1 fees)
- Shareholder Service Fees
- Asset-Based Fees
- Margin Loan Interest
- Account Service Fees
  - Wire Transfer Fees
  - Account Maintenance Fees
  - IRA Fees
  - Account Inactivity Fees
  - Minimum Account Fees
- Money Market Fund Management Fee
- Soft dollars

A brief description of each of these types of commissions or fees follows:

Trade Commissions

In its simplest form, a trading commission is a charge that a brokerage firm assesses for executing a trade for a client. The charge can be a flat fee, an amount per share, or a minimum fee plus a charge per share. For instance, a broker may charge a $25 commission on any trade up to 1,000 shares and $0.03/share on trades over 1,000 shares. Trading commissions are normally shared between the individual broker and the brokerage firm. As a general rule, trading commission rates will be higher at full-service brokerage firms as compared to discount firms.

Mutual Fund Sales Charges (Loads)

Typically, when a broker buys or sells shares of a mutual fund for a client, the client pays a sales charge (either directly or indirectly), or "load", which is paid to the brokerage firm by the mutual fund company. This is in contrast to "no load" funds, which pay no selling compensation for shares sold by brokers, and shares are instead sold directly to investors. Sales charges imposed by load funds may be charged to the client at the time the fund is purchased (front-end load), or over time (back-end or level load).

Front-End Load

The front-end load is a sales charge paid to the brokerage firm at the time the client purchases a fund through a broker. Front-end loads are typically associated with mutual fund "Class A" shares. Front-end loads will directly reduce the amount of the client's investment. For example, a client using a broker to buy $100,000 of a class A share fund with a 5% front-end load will end up owning shares in the fund worth $95,000. The other $5,000 will be paid to the brokerage firm and shared in some ratio between the firm and the broker. The size of the front-end load can range from 0% to 8.5%, although 5% is most common. Regardless of the amount, the client bears the cost of the sales charge primarily when money is invested in the fund.

Back-End Load

A back-end load is a sales charge paid to the brokerage firm by the mutual fund company when the client invests, but it is not immediately deducted from the client's investment. This type of load typically applies to mutual fund "Class B" shares. In this case, the client will bear the cost of the sales charge over a period of time. The sales charge paid to the brokerage firm by the mutual fund company is similar in amount to front-end load funds (i.e., $5,000 on $100,000 invested would not be uncommon). On back-end load funds, the mutual fund company will be charging higher annual fees inside the mutual fund on the client's investment as a means of recovering the money advanced to the selling brokerage firm. These fees are in addition to the fund's expense ratio and are referred to as "12(b)-1 fees", named after the section number in the enabling legislation which permits such fees. For a given mutual fund which offers front-end and back-end load shares (Class A and Class B), it would not be unusual for the Class B shares to have internal charges on an annual basis that amount to an extra 1.0% (in addition to the expense ratio). Thus, the mutual fund company might advance a selling commission of 5.0% of the investment on day one to the brokerage firm and expect to earn 1.0% extra per year in internal 12(b)-1 fees.

The mutual fund company is at risk if the client does not retain the investment long enough for the annual fees to recover the commission advanced on day one. Thus, such shares typically have a "surrender charge" if redeemed before a suitable holding period. The back-end load typically declines as the client holds the fund, often reaching 0% if held long enough. A typical surrender charge schedule might be 6% in year one, declining 1% per year to 0% beginning in year seven.

Level/Low Load

A level load mutual fund ("Class C" shares) is similar to a back-end load fund in that the client is bearing the cost of the sales charge to the broker over a period of years in the form of higher annual charges inside the mutual fund. The principal difference is that the mutual fund company pays the sales charge compensation to the brokerage firm on a year-at-a-time basis rather than advancing it on the front end. The brokerage firm and the individual broker are paid over time, as long as the client retains the mutual fund investment. Since no money is advanced to the brokerage firm by the mutual fund company, there is no need for a surrender charge if the investor liquidates the funds early.

Shareholder Service Fees

Shareholder service fees are a specific type of distribution fee paid by a mutual fund to a brokerage firm. The shareholder service fee is paid to brokerage firms for the service of responding to investor inquiries about the mutual fund and to provide clients with information about their mutual fund investment.

Asset-Based Fees

Brokerage firms sometimes charge fees based upon a percentage of the value of the assets in a client's account. For instance, a brokerage firm may charge a client 0.75% of the value of their assets per year. These charges are established to cover the cost of trading and are charged in lieu of commissions on each trade. Asset-based fee structures for brokerage services are sometimes called "fee in lieu" as the asset-based fee is charged in lieu of brokerage commissions. Asset-based fees are often considered the most desirable fee structure for a brokerage firm because it is a stable annual fee and is not dependent upon actual trade activity. Whether this will prove advantageous to the individual client (compared to traditional trading commissions) depends on the level of trading that occurs in the client's portfolio. Similar to the fees discussed previously, any asset-based fees collected by the brokerage firm will normally be split between the firm and the individual broker.

There is considerable debate regarding brokers charging this type of fee. This issue is discussed in more detail in the Conflicts of Interest section.

Margin Loan Interest

Margin loan interest is an interest rate charged by brokerage firms for lending money to clients in the form of loans secured by the clients' portfolio assets. Most types of investments held in client accounts are eligible to act as collateral for margin loans. Collection of margin loan interest is a significant revenue and profit source for brokerage firms, and they typically share a portion of this revenue with the individual broker as an incentive to encourage clients to use the firm's margin lending capabilities.

Account Service Fees

Brokerage firms also are able to charge several types of account service fees. Examples include wire transfer fees, annual IRA account fees, account termination fees, account inactivity fees, minimum annual fees per account or other account maintenance fees. Account service fees are often small and can be easily overlooked by clients. In most cases, the brokerage firm retains the revenue, and no meaningful amount of such fees is shared with the individual broker.

Money Market Fund Management Fee

When a brokerage firm offers its own money market fund or cash sweep fund, a management fee is paid to the management company, which is typically an affiliate of the brokerage firm. The asset-based fee on these funds can be very lucrative to the broker and its affiliate, and it represents a direct cost to the client. Money market fund fees are paid directly out of the fund's assets and are reflected in lower yields provided to clients.

Soft Dollars

Some fee structures are nearly invisible to clients, but can be lucrative for the brokerage firm. So-called "soft dollars" are commissions generated by investment managers placing trades with a specific brokerage firm, where in exchange, the brokerage firm provides some service or benefit to the investment manager. While the brokerage firm might not pay the investment manager directly for this business, it can pay for services used by the investment manager that benefit the investment manager's clients. For example, brokerage firms can pay for investment research services such as Bloomberg, or industry reports from Standard & Poor's. On the other hand, soft dollars cannot pay for items unrelated to investment decision-making such as rent or utilities. Soft dollar arrangements have been under fire for some time because they result in commissions that are higher than those of a normal transaction. In essence, the brokerage firm makes more money in commissions under a soft-dollar arrangement, even after it pays for the research services for the investment manager.

Fiduciary Advisors: Roles and Compensation

The Role of the Fiduciary Advisor and Advisory Firms

As discussed in the introductory comments, a fiduciary advisor primarily provides advice to clients regarding investments and wealth management. "Advice" might be so extensive as to include discretionary management of daily portfolio investment decisions. Or, it could simply be counsel about decisions that clients reserve to make on their own. Compensation is typically received as some type of fee.

The specific services provided by fiduciary advisors include some or all of the following (though this list is not necessarily all-inclusive):

- Financial Planning
  - Assistance Defining Financial Goals and Objectives
  - Life Insurance and Risk Management Advice (as distinguished from selling insurance policies)
  - Savings Planning
  - Retirement Planning
  - Education Planning
  - Investment and Portfolio Planning
  - Budgeting
  - Financial Forecasting
  - Tax Planning (income and estate taxes)
- Portfolio Management

Fiduciary advisory firms are generally smaller and less recognized than brokerage firms. Mutual fund managers such as Vanguard, Pacific Investment Management Company (PIMCO), and T. Rowe Price are examples of some of the largest fiduciary advisory firms. These firms manage client portfolios either directly or through mutual funds, and each is required to act in the best interest of their clients, putting their own interests second. While the largest fiduciary advisory firms are generally mutual fund managers, smaller firms exist in all major cities in the US. Some fiduciary advisory firms may be as small as one or two professionals, while the largest mutual fund managers have thousands of employees.

Regardless of size, the fiduciary advisor is subject to the legal standard of a fiduciary. As mentioned, a fiduciary is an individual or firm held to a legal standard that requires acting in the best interest of their clients regardless of the situation (fiduciary duty). A fiduciary must always put their clients' interests first. When a conflict of interest is unavoidable, the fiduciary has a duty to disclose the conflict to the client.

A fiduciary investment advisory firm must be licensed as a Registered Investment Advisor (RIA) in order to dispense investment advice. The RIA firm is registered with the Securities and Exchange Commission and/or the state securities department. In addition, each individual acting in a fiduciary advisory role for the firm must be licensed to provide investment advice, which requires he or she pass a series of tests. While it is possible for individuals to be both a fiduciary and a broker, they are required to disclose to the client the capacity in which they are operating with respect to each service they provide.

Fiduciary Compensation

Fiduciary advisors are normally compensated by charging an ongoing percentage of the assets they manage or supervise (e.g., 1.0% of assets annually). They may also charge a flat fee or an hourly rate for certain services. The compensation is relatively straightforward in that it is paid by the client directly to the advisor or firm. Compensation is not typically paid to the advisor by any third parties such as insurance companies, mutual fund companies, or investment sponsors. Fee structures for fiduciaries should be transparent and understandable to the client and as free as possible of conflicts of interest between the advisor and the client.

The most common fee structure (a percentage of assets managed or supervised) is recognized as effective in aligning the client's goals with the fiduciary investment advisor's goals. In essence, if the client's portfolio rises in value, the advisor's fees increase. If the value of the client's portfolio declines, the advisor collects less. Fiduciary investment advisors do not charge nor should they accept commissions or other forms of compensation from third parties, as these would result in a conflict of interest.

Conflicts of Interest: Brokers and Fiduciary Advisors

Because of the variety of direct and indirect ways brokerage firms generate revenue, it is not hard to imagine situations where conflicts of interest can arise between the brokerage firm and the client. In fact, the conflict of interest issue is at the heart of regulatory debate today and has been central to regulatory attempts for centuries.

As discussed earlier, brokers are held to a standard known as suitability. Quite simply, they must have a reasonable basis for recommending a security or investment strategy in light of the client's financial condition. They need not ask whether this is the best product to meet the client's goals and objectives, nor do they need be concerned about whether less expensive alternatives exist. In reality, the broker must believe the recommended investment is suitable for their client and that the client understands the investment. The following describes three hypothetical situations that can arise in a relationship between a client and a broker that can test the conflict of interest issue. These hypothetical situations do not necessarily attempt to describe every conceivable conflict (that would be impractical), but do serve to illustrate those types of conflicts that generally do not arise in the case of the same relationship between the client and a fiduciary advisor.

Situation 1: The Stock Portfolio

A client engages a broker to build a portfolio of common stocks with the agreement that the broker will be compensated through the trading commissions charged by his brokerage firm.

One of the most basic conflicts of interests in the brokerage world is the fact that more trading (and the more charged per trade) generates more commissions for the broker and the brokerage firm. Thus, the broker is exposed to the temptation to encourage the client to trade more frequently, even if doing so may not be in the client's best interest. At its extreme, this activity is called "churning". The broker's agenda could possibly conflict with that of the client, since retention of stocks for long periods of time would lower the broker's income.

In contrast, a fiduciary advisor would typically be compensated by a percentage of the portfolio's value. As the account grows, compensation increases; as it declines, compensation decreases. It is in the advisor's best interest to minimize the client's transaction costs through the utilization of discounted brokerage rates, wherever feasible. While the total dollars paid by the client to a fiduciary advisor may be greater than the commissions paid to the broker in the same situation, there is nonetheless a better alignment of the client's interest with that of the advisor, giving the advisor an incentive to act in the client's best interest.

Situation 2: The Mutual Fund Portfolio

A client engages a broker to create a diversified portfolio using various mutual funds to accomplish the client's portfolio goals. Since the mutual funds will likely be held for an extended period of time, the client considers that compensating the broker through a one-time commission might be the best approach.

Brokers may be offered different commission payout rates by their brokerage firms for different products which can conflict with their recommendations to customers. Even if the broker receives the same payout percentage on all mutual funds, the fact is all mutual funds do not offer the same total commission payment to the brokerage firm. Both market realities add an immediate conflict of interest to the broker in selecting funds for the client. The best investment for a client (perhaps the "Acme Fund" which pays a 4.0% front-end commission to the firm on Class A shares) might not be the one that pays the brokerage firm the most. For example, the broker could instead suggest the "Smith Fund" which pays a 6.0% front-end commission to the firm. If the client is investing $300,000 in the fund, the difference in sales load could be $18,000 versus $12,000.

Similarly, many brokerage firms earn more money when their own mutual fund products are used. Thus, if a Smith & Co. broker recommends a Smith Series mutual fund, the client will need to ask if the recommendation is because that fund is the best possible investment for that portfolio, or is it simply a suitable investment that provides the broker with a larger payout? This conflict is generally known as the incentive to push in-house product. Brokerage firms have been heavily criticized in recent years over this obvious conflict and have generally moved towards leveling the payout rate between in-house mutual funds and externally managed funds. Nonetheless, brokers recognize their employer benefits when in-house funds are used, and some indirect pressure to utilize such investment options for clients is unavoidable.

Another perverse reality faced by brokers is selection of mutual fund investments for clients from among the many share classes that may be offered by a fund. Assume our same example as above, but assume the client has $3 million to invest in mutual funds. In this situation, the broker must choose to do one of the following:

1) Recommend all funds be invested in mutual funds, which are members of a single-fund family (likely resulting in the lowest sales charge to the client and the lowest pay for the broker);

2) Make a reasonable case that no one fund family can be the "best in class" for all investment disciplines and that the client should divide the portfolio amount into five or six fund families;

3) Suggest Class B shares which do not impose an up-front sales charge against the client's investment.

These three possible recommendations make a considerable difference in the amount of compensation received by the brokerage firm (and the broker). While there are variations from fund family to fund family, the following is a reasonable portrayal of how much income the brokerage firm might receive under each of these recommendations:

- Choice 1: $37,500
- Choice 2: $112,500
- Choice 3: $150,000

It is not hard to imagine that such a difference in potential compensation for essentially the same service will test the conscience of even the most honest, well-intentioned brokerage professional.

In contrast, a fiduciary advisor would likely build out the recommended portfolio utilizing no-load mutual funds that levy no sales charges, and instead charge the client a direct fee for the advice and supervision provided. Although fee schedules vary among fiduciary advisors, a charge of 0.75% per annum on a portfolio of $3 million would not be uncommon. The client would begin paying the advisor $22,500 per year to manage the portfolio and continue compensating the advisor on a "pay as you go" basis. The client would typically be free to terminate the relationship without further payment at any point if he or she did not believe the advisor was adding appropriate value to the relationship. When the portfolio grows or decreases in value, the advisor's fee grows and decreases accordingly.

Situation 3: The Bond Portfolio

> *A client approaches a broker with $1 million and desires a portfolio of conservative bond investments with an intention of holding the investments through their maturity and earning the interest income.*

While this might seem like a "textbook example" of a client being better served by paying a one-time commission to the brokerage firm for acquiring the bonds, as opposed to some type of on-going management fee, it is unfortunately more complicated than that.

Principal trading by brokerage firms poses possible conflict of interest issues. Brokerage firms are allowed to hold positions for their own benefit as inventory. They may buy (or sell) securities for (from) their own account from (to) their clients. This is known as principal trading. In contrast, trading as an agent means the broker finds the bond from an outside source (another firm, for example), buys it for the client, and charges a commission. Brokerage firms are allowed to conduct principal trades, but they are required to disclose them to their clients. Clients are not informed, however, of the dollar amount of mark-up earned on such trades by the firm.

Think about the practical effect of this upon the broker charged with finding ten municipal bonds to create a $1 million portfolio for his client. When the client leaves his office, the broker picks up the phone and calls his fixed-income trading desk at the brokerage firm. He describes the parameters of what he is looking for on behalf of the client (maturity, quality level, etc.). Several things then happen which affect the bond portfolio to be owned by this client:

1. Where does the fixed income trader go first to look for appropriate bonds—out to the street or to the firm's own inventory? There is a clear incentive for the firm to utilize its own inventory to fill the order wherever possible since this is a more profitable solution. For example, the firm may have in its inventory a $100,000 municipal bond issued by an AA-rated municipality which yields 4.0% for 10 years. Its profit on selling the bond to the client may be $2,500. Alternatively, the firm may be able to find another equivalent AA-rated municipal bond yielding 4.2% for the same 10 years, but because the bond must be acquired from another brokerage firm, the potential compensation is only $500. Both bonds are "suitable" for the client. Which one is likely to be recommended?

2. Once suitable bonds are assembled by the trader, the trader comes back to the broker and asks, "How much do you want to make on these bonds for your client?" In all likelihood, the brokerage firm has some guidelines to give the broker some parameters on how much or how little can be charged to clients for bond transactions, so this is not completely open-ended. However, a client investing $1 million in bonds is purchasing 1,000 bonds. The range of permissible compensation that can be built into the price of each bond might be as small as $0.25 per bond, or as much as $10.00. Usually, the permitted maximum charge will be related to the bond's maturity. However, because there is leeway to vary the charge, the broker is essentially put in the position of asking himself, "How much do I think my client will stand for?" Every extra dollar of mark-up for broker compensation reduces the yield-to-maturity on the bond.

A fiduciary advisor can also assemble and manage a bond portfolio for a client, but will typically do this for a management fee. Sometimes, the management fee level for an all fixed-income portfolio might be lower than that of balanced portfolios or equity portfolios. Regardless, the conflicts outlined above do not exist for the fiduciary advisor. He or she is motivated to obtain the best possible yield-to-maturity for the client by making prudent purchases of bonds (generally through "comparison shopping" among multiple brokerage firms). Since the fiduciary advisor is charging an on-going fee to the client, there is a continuous burden to demonstrate to the client that value is being added on a year-by-year basis (handling bond calls and reinvestments wisely, monitoring credit quality, etc.).

Other Conflict Issues

Other less direct issues exist with respect to brokerage houses' conflict of interests. One area that is immensely profitable for brokerage firms who are part of an investment bank is underwriting. Investment banks charge large fees to assist companies in raising capital from investors. This process is referred to as underwriting. If the investment bank is also a brokerage firm, they can make even more money by directing (encouraging) their brokers to sell shares of the underwriting client to its brokerage clients. This is commonly referred to as "in-house distribution" and is a very profitable way of selling the underwritten firm's investment and raising the needed capital.

Another issue related to firms that have both an investment bank and a brokerage sales force relates to research offered. Brokers often offer research reports to their clients in hopes the client might buy or sell a security. In principal, this might appear to be a valuable add-on service. However, one must consider that if the investment banking side of the firm makes money by underwriting company offerings, how reliable are the reports their research teams generate. Investment banking clients do not like to see their stock rated as a sell. As a result, few investment banks will post a sell rating on their banking clients' shares.

Confusion in the Marketplace

After considering the various issues discussed in this paper, many individual investors readily agree it is in their best interest to engage the services of an advisor who will act in a fiduciary capacity.

Unfortunately, it is becoming increasingly difficult for an individual to differentiate between who is acting as a broker and who is acting as a fiduciary. It is no longer possible to immediately discern by title alone whether someone is providing advice as a fiduciary or whether he or she is simply providing brokerage services.

The recommendation may take the form of advice, but is it truly advice, or is it a sales pitch? In the last 10 years, brokers at the major brokerage firms have adopted many titles such as:

- Registered Representative (or Registered Rep.)
- Broker
- Advisor
- Financial Advisor
- Financial Planner
- Financial Counselor
- Financial Consultant

Some argue that the muddying of the waters by these various titles has been intentional. The following are disclaimers found in the disclosures area of a major Wall Street brokerage firm's investment proposal:

> "This Proposal was generated using a brokerage tool and is not a financial plan and does not create an advisory relationship among you and your broker"

> "This Report…creates a brokerage relationship among you, your financial advisor and XYZ Firm. You should understand the differences between a brokerage and a fiduciary relationship. These (Fiduciary) obligations govern our conduct and disclosure requirements, creating a high legal standard which is referred to as a "fiduciary" duty to you. The decision as to when and how to invest are solely the client's responsibility. Timing for implementing, monitoring and adjusting your investment strategies is a critical element in achieving your financial objectives, and is solely your responsibility."

Conclusion

The issue ultimately boils down to one of liability. Fiduciaries are held to a higher legal standard than brokerage firms. Brokerage firms are not anxious to take on a higher legal standard and have fought ferociously for an exemption so that they could charge an asset-based fee for brokerage (providing a nice stable revenue stream not dependent upon trade volume), and provide investment advice without being considered a fiduciary. In 2005, as the popularity of fee-based brokerage pricing structures grew, the SEC declared brokerage houses did not have to fall under the fiduciary standard if they provided advice as part of a fee-based brokerage pricing structure. This exemption provided that advice given that is incidental to brokerage services does not need to fall under the fiduciary standard and its heightened potential liability. This exemption is known as the "Merrill Rule". In 2007, the court struck down this exemption, basically reasoning that advice is advice regardless of whether it is provided in the course of providing brokerage services. In 2010, the Frank Dodd Wall Street Reform and Consumer Protection Act directed the SEC to conduct a study to decide how to handle regulation of brokerage services and investment advice. The industry is eagerly awaiting the decision about whether or not brokerage firms will have to adhere to the fiduciary standard when providing advice. Most in the industry agree the SEC is not likely to provide any guidance anytime soon. The SEC claims it is understaffed and does not have the resources to carry out the study.

For the time being, in an attempt to clarify whether or not brokerage houses were acting as a broker or as a fiduciary, the SEC required brokerage houses to include the following text on their account forms, "Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and sometimes by people who compensate us based upon what you buy. Therefore, our profits and our salespersons' compensation may vary by product and over time."

Helpful Web Sites / Articles

www.fi360.com
www.focusonfiduciary.com
www.seekingalpha.com
www.seniormarketadvisor.com

Brokerage Standard Vs. Fiduciary Standard
http://www.ehow.com/ about_7285519_brokerage-standard-vs_-fiduciary-standard.html

Suitability: Where Brokers Fail
http://www.forbes.com/2009/06/23/suitability-standards-fiduciary-intelligent-investing-brokers.html

Fiduciary Responsibility: A Likely New Standard For Brokers
http://seekingalpha.com/article/145545-fiduciary-responsibility-a-likely-new-standard-for-brokers

Can You Trust Your Financial Adviser?
http://articles.moneycentral.msn.com/RetirementandWills/CreateaPlan/CanYouTrustYourFinancialAdviser.aspx

Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?
http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/Schanzenbach_Sitkoff_580.pdf

Footnotes

[1] The Investment Advisers Act (IAA), also called Advisers Act, is a federal act that defines the role of an investment advisor, and requires such advisors to register with the SEC. The act also sets standards for advertising, disclosure, fees, liability, and record keeping. The IAA was passed in 1940 in order to monitor those who, for a fee, advise people, pension funds, and institutions on investment matters. Impetus for passage of the act began with the Public Utility Holding Company Act of 1935, which authorized the Securities and Exchange Commission (SEC) to study investment trusts. The thrust of this study, which led to the passage of the Investment Company Act of 1940 and the Investment Advisers Act, was to provide a closer look at investment trusts and investment companies. The study, however, found many instances of investment advisor abuse such as unfounded "hot tips" and questionable performance fees. The IAA sought not to regulate investment advisors so much as to keep track of who was in the industry and what their methods of operation were. The IAA does not mandate qualifications for becoming an investment advisor, but it does require registration for those using the mails to conduct investment counseling business.

[2] The courtiers de change were concerned with managing and regulating the debts of agricultural communities on behalf of the banks. As these men also traded in debts, they could be called the first brokers.
(Read more: www.reference.com/browse/stock-brokerage.)

[3] In 1698 John Castaing began to issue "at this Office in Jonathan's Coffee-house" a list of stock and commodity prices called The Course of the Exchange and Other Things. It is the earliest evidence of organized trading in marketable securities in London. That same year, stock dealers were expelled from the Royal Exchange for rowdiness and started to operate in nearby streets and coffee houses, in particular at Jonathan's Coffee House in Change Alley. The establishment was later burned down in 1748. New Jonathan's was built without delay, supported by various brokers, and soon took on the name of The Stocks Exchange. The coffee house was close to the site of London's original livestock market (The 'Stocks Market); the two were soon combined, and the London Stock Market was born.
(Read more: www.londonstockexchange.com/about-the-exchange/company-overview/our-history/our-history.htm.)

[4] Founded in 1711, the South Sea Company was a British joint stock company that was granted a monopoly of the slave trade in Spain's South American colonies as part of a treaty during the War of Spanish Succession. In exchange, the company assumed the national debt England had incurred during the war. Parliament's acceptance of a proposal by the South Sea Co. to take over the national debt resulted in an immediate rise in its stock, which ultimately led to the "South Sea Bubble". An inquiry by the House of Commons found collusion by several government ministers. Nonetheless, the company was restructured and continued operation for more than a century after the Bubble.

[5] Modern portfolio theory (MPT) was developed by Harry Markowitz and published under the title "Portfolio Selection" in the 1952 Journal of Finance. Its development continued through the 1970's. The theory is a mathematical formulation of the diversification of assets, with the aim of building a portfolio of investment assets that has collectively lower risk than any individual asset. Although widely used in practice in the financial industry, and although several of its creators won a Nobel memorial prize for the theory, the basic assumptions of MPT have been widely challenged by fields such as behavioral economics in recent years.
(Read more: http://www.investopedia.com/articles/06/MPT.asp.)

[6] The "Merrill Lynch Rule" or "Merrill Rule" was first proposed in 1999 and formally adopted in 2005. The rule allowed stockbrokers to act as "advisors" and to charge a percent of assets as fees. Prior to the rule, only investment advisors who registered with the SEC or with the states and who were regulated under the Investment Advisers Act of 1940 were permitted to do this. Under the Merrill Lynch Rule, brokers could call themselves advisors, yet remain exempt from regulation under the Investment Advisers Act, as amended. The US Appeals Court decided the SEC had exceeded its authority in granting this exemption to stockbrokers. The ruling found no congressional intent to "support the SEC's interpretation of its authority." These legal proceedings were prompted when the SEC adopted the rule in 2005 and was then sued by the Financial Planning Association and the Consumer Federation of America.

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