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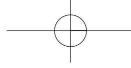
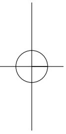
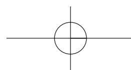
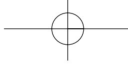


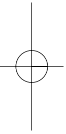
Part One

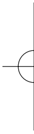
The Financial Advisor's Role

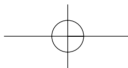












CHAPTER 1

The Regulatory and Ethical Environment

Most narrowly defined, a *financial advisor* is someone who is required to register under the Investment Advisers Act of 1940 because he is paid to give advice about investing in securities. A more expansive definition, one that includes financial planners, attorneys, accountants, financial analysts, insurance agents, stockbrokers, bankers, traditional management consultants—and even "incubators" or "accelerators," who invest in promising start-ups by providing Web development, business development services, and fund-raising assistance—would recognize that, like their entrepreneur clients, those who provide financial advice are both agents and objects of change.

After more than 20 years of wrangling, the Gramm-Leach-Bliley Act of 1999 eliminated Depression-era federal and state statutory barriers to affiliations among banks and securities firms, insurance companies and other financial service providers. The act also created the National Association of Registered Agents and Brokers to function as an agent-licensing clearinghouse in the event the Producer Licensing Model Act is not successful by November 2002 in allowing insurance agents and brokers to use their home-state licenses to conduct their business in other states.

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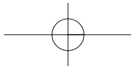


Financial industry and financial service professionals are feeling a culture shock that will forever alter the way in which they function. Entrepreneurial and other clients are better informed and more sophisticated, and they demand cutting-edge, accurate, and fairly priced advice. At the same time, technology has made commodities of many financial services, making it increasingly difficult for financial service providers to distinguish themselves from one another.

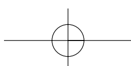
The business models that financial service providers are pursuing compound the problem. Banks, insurance firms, and stockbrokers are gobbling up one another, and while they struggle with privacy and logistics issues, they hold themselves out as holistic healers. Lawyers, accountants, and financial planners team up, through reciprocal referral arrangements and multidisciplinary practices, to serve their clients across geographic boundaries more broadly and deeply than they could on their own.

Whether we endorse or resist these new, perhaps revolutionary formulations, they are here to stay: Financial advisors are likely to institutionalize their relationships, to focus on identifying and solving their clients' problems, and to forgo short-term profits to reinvest in their businesses and practices for long-term growth and competitiveness.

Duties of a Fiduciary

Although strategic considerations may force 21st century financial advisors to rethink their mode of practice, their duties to their clients will not diminish and, in fact, the growing complexity of the advisors' business networks give rise to new ethical challenges. Professional codes of conduct, common-law principles, and statutes spell out advisors' obligations as fiduciaries—to put the client's interest above their own, to disclose any conflicts of interest that may compromise the client, to obtain the client's consent to any such conflicts, and ultimately to protect the client.

To be perfectly clear about it, not everyone who renders financial advice is in fact a fiduciary, one in whom a client reposes trust and confidence and, for that reason, one who owes the client the highest duty of undivided loyalty. Bankers, for example, enter into arm's-length transactions with their customers and, along the way, they give advice. And insurers, who exist to sell policies, may offer their customers help with loss control. Yet, in each case, their customers recognize that the under-



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lying business relationship is not one where the advisors are expected to hold their customer's interests above their own. And, after all, it is the consumer's reasonable expectation that triggers a fiduciary duty.

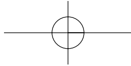
Simply put, where trust is expected, it ought to be delivered. The sometimes ambiguous example of the financial planner is instructive. Financial planning is an occupation in transition. For many years, one became a financial planner by self-designation. Now, financial planning is evolving into a profession, and its leaders, recognizing that they serve clients and not customers, embrace the fiduciary label.

The Financial Planning Association, the licensor of the Certified Financial Planner® (CFP) mark and the leading organization of financial planners, in its Code of Ethics, assumes "responsibilities to the public, to clients, to colleagues, and to employees." The code provides guidance to its members through principles it adopts relating to integrity, objectivity, competence, fairness, confidentiality, professionalism, and diligence.

Some planners contend that only advisors who work with employee benefit plans, and not those who represent the entrepreneur and other individuals, are fiducuaries. The weight of legal authority is against them: Just about anyone who gives advice and holds himself or herself out as a financial planner is required to register under the 1940 Investment Advisers Act and thus becomes a fiduciary. And the paradigm shift in the financial services industry presages that, as advisors render services collaboratively, they are likely to be held to the highest standard applying to one of them. So the consumer would reasonably expect.

Once planners acknowledge that they are fiduciaries, they may be forced to establish a process by which investment issues are made. The Uniform Prudent Investor Act, which applies to investments by trusts and trustees, deserves the attention of all investment advisors. It judges them on their performance. Accordingly, investment advisors are required to prepare written investment policy statements and document each and every step of the implementation of the policies they have adopted. After all, the client has hired a professional to bring discipline to investing and is entitled to the benefit of that bargain.

The investment advisor needs to understand the client's risk tolerance and time horizon and must develop an appropriate asset and subasset allocation. It becomes the investment advisor's job to select investments or to choose a money manager or mutual fund for each asset class. Money managers or mutual funds should be selected based on their risk-adjusted performance



vis-à-vis other investments in their peer group (including performance in rising and falling markets), their adherence to investment style, and the tenure of their decision makers.

Financial advisors need to manage and control expenses. Thus, if they select load funds, it is incumbent on them to justify that decision.

Financial advisors' most central obligation is the duty of full disclosure to their clients. Disclosure usually begins at the initial client interview, which is intended to ascertain whether or not the advisor and the prospective client are a good fit. In representing entrepreneurs, the question is a particularly important and complex one since, depending on the nature and scope of the engagement, the advisor may end up rendering ad hoc advice under demanding time constraints, much of it based on instinct and intuition. Chemistry becomes critical under such circumstances, and the time to test whether advisor and client are "in synch" will long since have passed.

Initial Interview

It is imperative that an initial interview with a prospective client identify all the relevant issues. To the extent the entrepreneur has not asked all the questions she reasonably needs to have answered in selecting a financial advisor for the engagement at hand, the advisor should help her frame the issues. They will almost always include the following:

- What experience do you have? Make sure the entrepreneur knows how long you have been a financial advisor and how your experience with other entrepreneurs relates to her needs and her objectives.
- What are your qualifications? All kinds of people describe themselves as financial advisors. Make sure the entrepreneur understands what credentials you hold and exactly what qualifies you to render the advice she seeks.
- What services do you offer? Make sure the entrepreneur is aware of your licenses and expertise—and all the ways you can provide help.
- How would you approach my situation? The answer to this question will give you the opportunity to share your philosophy, but it also demonstrates how you have helped entrepreneurs with similar needs.
- Will you be the only person working with me? The entrepreneur needs to know how you work and who is on your team. If others in your

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office will be participating in the engagement, the entrepreneur has a right to meet them and satisfy herself about their skills and experience. If the financial advisor will be collaborating with other professionals he selects, the entrepreneur should know that, too, and learn their backgrounds.

- How do you get paid for your services? There should be no mystery here. The entrepreneur is entitled to know how and when the advisor is paid and should feel comfortable that the advisor's compensation is fair.

Compensation Approaches

Not surprisingly, fees are the greatest source of controversy between advisors and clients, yet advisors often have little but their instincts to rely on in formulating fees and disclosing them. Different kinds of financial advisors are likely to be compensated in different ways. Each would be prudent to document his fee structure and have the client sign off on it.

Following are some typical compensation patterns and the advantages and disadvantages of each.

Flat Fees. Financial advisors of all stripes take on engagements for an agreed sum. Their clients have the comfort of knowing exactly what the work will cost and thus might be more inclined to authorize it. However, advisors run the risk that the engagement will take longer than they thought and they'll be obligated to "eat" some time.

Hourly Fees. Attorneys and accountants customarily bill by the hour, and so does a growing number of financial planners. The advisor expects to be compensated for all time spent and can budget accordingly, but will not earn a premium for achieving extraordinary results. Hourly rates do not automatically avoid conflict-of-interest issues: a client may conclude that the advisor took longer or billed more to do the work than the client thought he should. To avoid any surprise, it is a good idea for the advisor and the client to develop a budget; clients prefer hourly billings only when the costs the advisor requests can be reasonably predicted and comfortably afforded.

Equity Arrangements. More and more attorneys, accountants, and other financial advisors are providing counsel to their entrepreneurial clients

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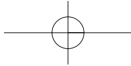

for a piece of the action, that is, stock, stock options, or warrants (equity equivalents). Clients gain the advice of an advisor they might not otherwise be able to hire or retain; the clients' cash, always in short supply, can be devoted to other purposes; and advisors will be highly motivated since they have a vested interest in the venture's success. All of this can be offset by the chilling reality that the advisors' loyalty may now be divided between their clients and themselves. Some professionals have concluded that equity arrangements present a conflict of interest that cannot be overcome by disclosure and consent. Their argument is a compelling one.

Commissions. Registered securities representatives and the broker-dealers that employ them historically have been paid for their investment advice by charging a commission on the financial products they sell to their clients. So have insurance agents. The industry is moving away from commission-driven to fee-driven compensation approaches because of the potential for conflicts of interest inherent to commissions. Horror stories about "churning" and unauthorized trading tend to support that concern.

Clients should understand that advisors' compensation methods render them neither more nor less ethical than they would be were they to be paid in some other fashion. And there are good client-oriented reasons for the advisor to maintain a commission-based business. For example, many investment professionals are simply dissatisfied with no-load life and disability insurance policies and have no choice but to collect a commission when they sell the policies or mutual funds they genuinely believe to be in their clients' best interests.

If an investment professional manages his client's portfolio of individual stocks and bonds for long-term total return, the account may see little turnover, and commissions may be significantly lower than a typical management fee might be. If the advisor selects no-load mutual funds for his client, the annual fee he would need to charge, added to the funds' management fees, might well be more expensive for the client than her investment in load funds that pay a commission to the advisor. No-load fund sponsors might also refuse to send the advisor the monthly statements he needs to track the investment performance and effectively manage his clients' assets. Finally, no-load funds notoriously attract inexperienced investors who are not committed to the long term. Some analysts fear that such shareholders could force fund managers to sell

holdings in down markets to make good on redemption requests born of panic.

Assets under Management. Rather than charge a commission, an increasing number of investment advisors charge an annual management fee based on the value of a client's assets. The client may perceive such a compensation method as creating incentive for the advisor to do a good job; as assets soar, so will the fee, and both the client and the advisor will prosper. In reality, the economics of asset-based fees may prove less or more fair than other approaches. The portfolio's turnover, the client's time horizon and risk tolerance, the manager's investment style, and prevailing market conditions all complicate the comparison.

Variations of These Themes. The ways in which advisors are compensated are limited only by their imaginations. Creative advisors are developing structures that combine fees and commissions, that offset commissions against fees, and that use formulas to reflect the client's investment income and net worth and the complexity of the services the advisor performs. Entrepreneurs may even negotiate bonus fees for financial advisors who are successful at consummating deals for them. So long as the client's interest remains paramount, approaches that creatively address the legitimate needs of the advisor and reward him fairly for his effort and success are to be encouraged.

Even financial advisors who may not be professionals owe their clients a duty of fairness. Thus, the National Association of Insurance Commissioners has adopted a Life Insurance Fluctuation Model Regulation to address the fact that some life insurance companies and their agents have been overly aggressive in their product design and illustration practices. The regulation prescribes industry standards to make sure that life insurance illustrations educate consumers about the important features of the products they buy and are prepared in an actuarially sound manner.

Engagement Letter

Communicating fees to prospective clients raises legal, ethical, and business issues. Although advisors of different disciplines are required to meet different criteria, virtually any financial advisor would be well served by following up his initial consultation with an engagement letter.

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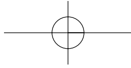


Its content would vary by profession but its intent would be the same—to define the scope of the advisor's work product, to set forth how he is to be paid, and to control client expectations.

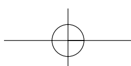
A lawyer's engagement letter, for example, would outline the services to be performed, how and when he is to be paid for them, disclaim any guarantee or assurance about outcome, and set the conditions under which he might withdraw from the engagement (if, for example, the client is not truthful with him, fails to take his advice, or does not pay his bills as they are rendered). Similarly, a financial planner's engagement letter would set forth the tasks the planner and his client discussed and the planner's estimate of his fees. The letter would be accompanied by the planner's Form ADV, Part II, the comprehensive disclosure document required to be given to prospective investment advisory clients under the 1940 act; it lays out the advisor's services and fees, educational and business background, conflicts of interest, and methods of analysis.

It is a good idea for the advisor to include an investment policy statement, one that lays out the client-specific risks of investing. The statement should be a product of a questionnaire designed to elicit information about the client's investment experience and knowledge, risk tolerance, investment time horizon, and expectations. The investment policy statement would be very helpful to the advisor should a lawsuit ever be brought against him.

Conflicts of Interest

Correspondence throughout the course of the engagement is useful to mitigate the risks of conflicts of interest. When there is a conflict, a possible conflict, or a perceived conflict, the financial advisor is wise to identify it, document it, and let the client know about all the alternatives available to her. If following an advisor's recommendation would increase the fee the client would pay, she has a right to know that, and the advisor has a duty to come clean.

Suppose an advisor is paid based on assets under management and his client who is approaching retirement age must decide whether to leave her 401(k) assets with her employer or roll them over into an individual retirement account (IRA). Or suppose the client needs help deciding whether to pay off his mortgage or add to his investment account. The



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advisor has a duty to disclose the conflict, and a duty to give her client a fair opportunity to make a fully informed judgment.

Not all conflicts are so obvious. There is the conflict of taking on more clients or more work than the advisor can handle competently. There is the conflict that results from allocating more time to one client than another. And there is the conflict advisors face as do all human beings—being more available to clients who are easier to work with. In each case the solution lies in the advisor's awareness of the issue and his consistency in being fair to his clients, to the process, and to himself.

Referrals and reciprocal agreements among financial advisors beg for full disclosure. The Financial Planning Association's Code of Ethics was derived from the Code of Ethics and Professional Responsibility of its predecessor, the Certified Financial Planners Board of Standards. It requires that CFPs disclose conflicts that "will or reasonably may impair the [CFP's] rendering of disinterested advice, recommendations or services." The principle is also found in the American Bar Association's Model Code of Professional Responsibility, which has been adopted as law in most states. It requires lawyers to avoid "even the appearance of professional impropriety" and demands that they exercise "independent professional judgment" when representing claims.

Members of the American Institute of Certified Public Accountants (CPAs) are required, under their Code of Professional Conduct, to "maintain objectivity and integrity" and be free of conflicts of interest in performing services. Where there is a conflict, a CPA can only work for a client after the client consents to the conflict, but may not perform "attest" services such as audits even with the client's consent.

Financial advisors, then, should be careful to make full disclosure to their clients:

- If they have a business affiliation with anyone whose products or services they are recommending
- If they are paid to sell someone else's products or services
- If they receive fees, commissions, or any benefits at all from anyone to whom they refer clients
- If they are affiliated in any way with a broker-dealer, a financial planner, an insurance company or agency, a law firm, an accounting firm, or anyone else who offers financial products or services

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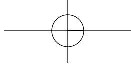

- If they are an owner of, or have any other relationship with, a firm whose products or services they recommend to clients

Risk itself presents conflict. Investment advisors who fully disclose the risk of a speculative investment may scare their clients away—and the revenue those clients represent along with them. Attorneys or accountants who discourage an entrepreneur from pursuing a flawed business opportunity act to their own short-term economic detriment. In each case, the advisors are doing the right thing for the right reason. Nothing convinces like conviction, and only by taking the high road do advisors meet their legal and ethical obligation to their clients and build the trust and rapport that are indispensable to the successful, long-term advisor-client relationship.