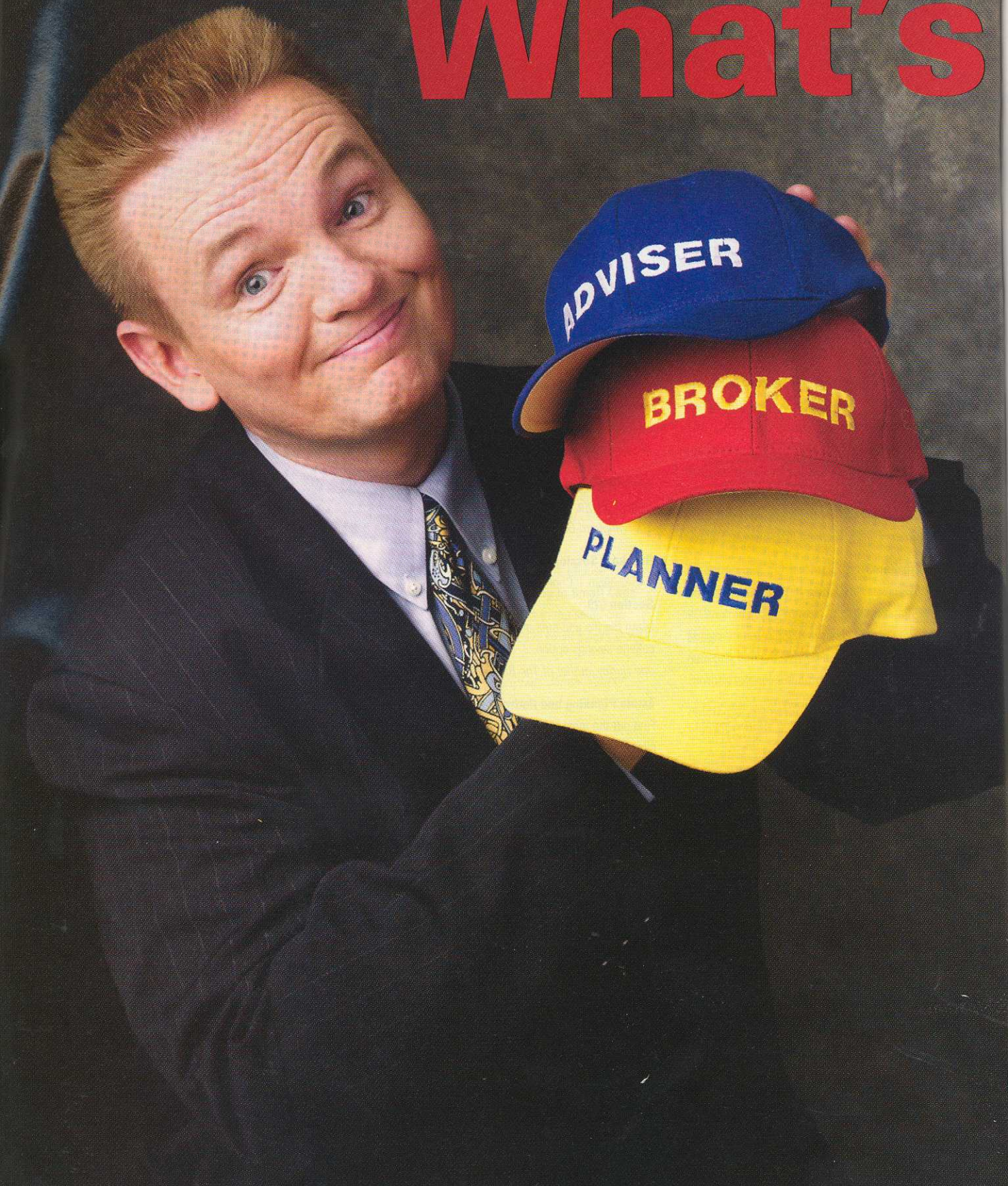


What's



In A Name?

Plenty. Whichever hat you wear, you may be setting yourself up for regulatory and civil malpractice exposure by mispositioning yourself in the marketplace. **By John McGovern**

A butcher? A baker? A candlestick maker? Such titles conjure up pictures of distinctly different service professionals. Can we say the same about a broker? A financial planner? An investment adviser? Do they speak to uniquely distinct professionals, or can they be one and the same person? ■ The answer to that question is not very simple, the distinctions not quite as functionally clear. A number of financial service professionals might have a problem answering it when asked of themselves, much less their peers. As a result, they may be setting themselves up for regulatory and civil malpractice exposure by mispositioning themselves in the marketplace as providing such uniquely distinct financial services, when in fact, they may not. ■ Each of these professions has separate, distinguishing characteristics, but they also have certain blurred similarities. Therefore, some time should be given to a brief review and description of certain basic functional definitions. When I use the term *functional*, I mean an examination of widely accepted, Old Economy marketplace protocols,

whether or not they fit today's New Economy realities. This will provide a foundation for an understanding of how failure to comprehend such functional definitions may lead to confusion among fellow professionals, legislators, regulators, attorneys and clients alike. ■ **Brokers.** In the Old Economy model of transaction-based brokerage compensation, this financial service professional's conflicts of interest were readily apparent. The broker was a salesperson who would receive transaction compensation only if the product he or she was representing was purchased. The broker's services involved qualifying the client for investment in products by determining his or her suitability (risk tolerance, goals and objectives) up to and including the point of sale. Obviously, from a business proposition, the broker would be expected to maintain an ongoing relationship with the client. However, the broker may not be contractually obligated to provide ongoing brokerage advice and counsel to the client, especially if there was no expectation of additional investable assets.

With respect to the aforementioned conflicts of interest, clients clearly understood that, if they did not agree with the product recommendation, the broker would not get paid.

The Old Economy model generally holds the broker to a “point-of-sale” suitability liability standard, which requires the conduct of a suitability analysis at the time the product is sold. However, based on the broker’s relationship with the client as well as the amount of potential ongoing business that the client might offer, the broker may decide to “fire and forget the client.” Absent a basic desire to maintain client goodwill, the broker may not be contractually obligated to revisit a nondiscretionary client’s portfolio allocation any time after the initial purchase.

Financial planners. Although there is no single industry-accepted definition of financial planning, regulatory or otherwise, I offer the following understanding as set forth by the Securities and Exchange Commission in its release IA-1092: “Financial planning typically involves providing a variety of services, principally advisory in nature, to individuals or families regarding the management of their financial resources based upon an analysis of client needs. Generally, financial planning services involve preparing a financial program for a client based on his or her financial circumstances and objectives. This information normally would cover present and anticipated assets and liabilities, including insurance, savings, investments and anticipated retirement or other employee benefits. A financial planner may develop tax or estate plans for clients or refer clients to an accountant or attorney for these services.”

A simple illustration of the financial planning process might entail a planner helping the client meet his goals and objectives by creating a cash-flow analysis, working with and advising the client as to the rearrangement of income and/or expenses to create discretionary cash flow in order to fund certain long-term objectives such as buying a house, planning for college, retirement, and so on. The functional definition of the financial planner is someone who offers clients his intellectual capital rather than someone deemed to be “pushing product.”

Investment advisers. The functional definition of an investment adviser, as set forth by Section 202(a)(11) of the Investment Advisers Act of 1940, is “any person who, for compensation, engages in the business of advising others, either directly or through publications or writing, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analysis or reports concerning securities.”

The investment adviser would traditionally set forth his objectivity by also charging a “fee-only” percentage of assets under management for providing such investment advice. He would not be deemed to be pushing products. The Old Economy investment adviser was widely accepted to be macro-economic, institutional, Peter Lynch-like professionals who managed millions or even billions of assets for their investment company, pension and other institutional or high-net-worth clients.

In addition, although financial planners may be regulated as investment advisers under the Investment Advisers Act of 1940, not all investment advisers are financial planners. I suspect that the Peter Lynches of the world probably secure the services of other professionals for their estate, tax planning and risk management needs. In addition, not all financial planners may necessarily be investment advisers, in the functional sense of those two terms.

New Economy Models

Despite their different definitions, the terms *broker*, *financial planner* and *investment adviser* appear to be used interchangeably these days—and that could spell trouble for the financial professional who uses the wrong word to describe his or her services. For instance, many professionals now use the term *financial planner* in their market positioning. However, due to lack of “classical training” (earning the Certified Financial Planner designation, for instance), they may be functionally mispositioned because of their lack of the requisite training necessary for the provision of such analytical, non-product-based services that their financial planning “shingle” suggests to the world.

Similarly, brokers are not only calling themselves advisers now, but also beginning to receive compensation based on a percentage of assets for providing brokerage recommendations not involving “more than incidental” investment advisory services. The shift to tying brokerage compensation to total assets may have caused these brokers to fail to grasp the important distinctions between the practice management risk models of the Old and New Economy. Basically, today’s brokerages have attempted to marry the point-of-sale service and liability concept with the continuous-compensation concept—but without understanding the fundamental, value-added distinctions between transaction-based, point-of-service liability and ongoing liability for continuous asset-based compensation.

We also see such firms blending planning and brokerage together with ongoing advisory services. In addition, they are also mixing transaction- with asset-based compensation.

As a result, the last 10 years have witnessed the emergence of a more retail-client-oriented adviser who offers to provide micro-economic, continuous advice and suitability analysis for ongoing receipt of asset-based compensation (past the point of sale) to retail accounts as low as \$25,000. Such advice promises to include an individual needs and suitability analysis together with ongoing investment performance reporting and appraisal; actual investment and portfolio recommendations may be “subbed out” to the institutional investment advisers. Thus, today’s advisers who hold themselves out as providing continuous advice and suitability analysis for ongoing receipt of asset-based compensation to individual retail clients obviously can not walk away from some type of ongoing suitability responsibility. That’s true no matter what term is used.

The period from 1992 to 2000 was more than favorable to our clients, thus limiting public and regulatory incentives to address certain practice management issues (e.g., stockbrokers holding themselves out as financial planners while failing to provide estate planning analysis, etc.). However, recent market conditions have caused clients to review their holdings and their financial service relationships more scrupulously. Therefore, retail advisers are wise to understand that by replacing the broker’s Old Economy model of point-of-sale compensation and liability with the New Economy model involving continuous compensation, they have taken themselves past point-of-sale suitability analysis and liability to a continuous or periodic ongoing review responsibility.

Removing the transaction-compensation element should not be intended to put the adviser in a passive, “if you don’t call me, I won’t call you mode” by simply creating a “renewal” or annuitized book of business. The Old Economy thinking of creating a “guaranteed revenue stream” is very dangerous if applied one-dimensionally to the high-tech advisory compensation model. Advisers should be aware that their clients still want and demand high touch; in fact, they are contractually due such value-added services.

Further, today’s New Economy adviser owes a higher standard of fiduciary responsibility to his or her clients than the Old Economy broker does. In that regard, the self-described adviser is first selling advice (i.e., intellectual capital), and that advice includes a fiduciary expectation that it contains recommendations (pricing and/or products) that are suitable for the client’s best interest. Product is or should be a secondary component of such services.

In addition, if you are a New Economy adviser, your

business plan requires you to set forth your value-added proposition. Are you an asset manager or asset gatherer—or both? If you fancy yourself an asset manager, do you have the requisite skill sets and experience to hold yourself up against your institutional counterparts (the Peter Lynches of the world)? On the other hand, if you are comfortable with the fact that you are an asset gatherer/servicer, have you set forth to your clients that service (as opposed to performance) is your value-added proposition? If you are holding yourself out in the sometimes mutually

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exclusive (by personal skill sets) roles of both asset manager and asset gatherer/servicer and you believe that you have both the quantitative and qualitative skill sets necessary for success, how have you found the time to do both?

Lastly, has your business plan taken into account pricing vs. services? What is your minimum account size? Are you providing continuous management or periodic portfolio performance reporting and appraisal? Does your pricing reflect the varying service levels that you are providing to your clients? Are you aware that a wrap program may be more suitable for clients who are more active traders? Further, have you considered unbundling the wrap for a fee-and-transaction cost program for clients whose investment objectives may not require active trading? Also, are you offsetting fees with commission because the account size is too small, or because such method is better for you? Finally, have you set compensation minimums and maximums higher for portfolios where you are providing continuous management and lower for portfolios where you are providing periodic performance appraisal and reporting?

Make sure that you are not part of today’s fashion trend—fee-based compensation—and tomorrow’s fashion faux pas: What has your adviser done for you lately?

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