Are You a Fiduciary?

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My two previous articles on how to protect your clients from their own instincts and the importance of performance continue to generate many e-mail messages and phone calls from readers.

Rick Ashburn of Richard Ashburn Investment Counsel in La Jolla, Calif., wrote,

> "Good advice pays off in many ways. But does that give financial planners an excuse to lose it all back through lousy asset management? Advisors shy away from selling performance because they're terrified someone will find out that they don't know what they're doing. Any advisor worth their various acronyms had better take performance seriously. Our clients hire us to manage their investments. If an advisor doesn't think hitting benchmarks is part of that charge, they should find another career."

Ashburn also mentioned performance reporting that is compliant with the Association for Investment Management and Research. Other readers wrote about the fiduciary standards of the American Institute of Certified Public Accountants. Some wrote to say, "I am not a fiduciary, so I don't care about any of those standards. They don't apply to me."

It seems that when it comes to fiduciary standards, some advisors are singing the Bob Dylan classic, "It Ain't Me Babe." But babe, it just may be you.

If you think you might ever be held to fiduciary standards, you may want to print and save this article.

Are You a Fiduciary?

I thank all the readers who wrote in to offer insights and interpretations of the fiduciary duty that advisors owe to clients. In particular, I thank Clark Blackman of Investec Advisory Group in Houston and Scott Simon of Prudent Investment Advisors in Carlsbad, Calif., for their input.

Simon is author of *The Prudent Investor Act: A Guide to Understanding* (Namborn Publishing, 2002), a book endorsed by John Bogle, founder of the Vanguard Group, and Harry M. Markowitz, the father of Modern Portfolio Theory. The broad range of other endorsements this book has received is a testimony to the growing importance of fiduciary duty.

According to Simon, there are two definitions of an investment fiduciary: 1) a person who has discretionary control over assets (e.g., money managers and custodians) or 2) a professional held in a capacity of trust and who renders investment advice (e.g., investment consultants). You may be surprised to learn that you do *not* need to have discretionary control over client assets to be deemed a fiduciary.

A fiduciary must *always* do what is in the client's best interest (even if it is not in his or her own best interest). Therefore, it may be a breach of fiduciary duty to recommend a S&P 500 mutual fund with a 5% load when you know of a fund with an equivalent track record that is no-load and has low annual expenses.

Further, as a fiduciary, it is not enough to simply do what is in your client's best interest. As a fiduciary, you must be able to prove in court that you have done what a "prudent man" (or a prudent person) would have done in that situation.

Much of my work over the past 20 years has been centered on helping financial advisors build dream practices. For some, that dream has meant multimillion-dollar practices. From my work as an expert witness in court, I have learned that it is one thing for an advisor to make several million dollars. It is another thing for an advisor to protect him- or herself enough to keep it. The purpose of this article is to show you *how to keep it*. A big part of that involves understanding and fulfilling your fiduciary duties.

Who is a fiduciary? Probably most readers of this column. Many of you are CFP® licensees. Fiduciary expert Simon states that "a CFP is a fiduciary and must put the interests of its clients ahead of its own." A number of rules in the Code of Ethics and Professional Responsibility issued by the Certified Financial Planner Board of Standards defines the fiduciary status of a Certified Financial Planner®. Rule 103(e): "A [CFP®] who takes custody of all or any part of a client's assets for investment purposes, shall do so with the care required of a fiduciary;" Rule 201: "A [CFP®] shall exercise reasonable and prudent professional judgment in providing professional services;" and Rule 202: "A financial planning practitioner shall act in the interest of the client."

A CFA Is Also a Fiduciary

The AIMR grants the Chartered Financial Analyst designation. The AIMR Code of Ethics and Standards of Professional Conduct, under the header, "Relationships with and responsibilities to clients and prospects," states:

"Fiduciary duties. In relationships with clients, members shall use particular care in determining applicable fiduciary duty and shall comply with such duty as to those persons and interests to whom the duty is owed. Members must act for the benefit of their clients and place their clients' interests before their own."

Others Who Could be Deemed Fiduciaries

According to Simon, an insurance agent who sells a life insurance policy to a fiduciary for a trust may be deemed a fiduciary. If the policy then underperforms relative to its original projections, the insurance agent may be held liable for breach of fiduciary duty. In this climate, it seems that almost anyone rendering investment advice could be deemed a fiduciary.

It is well-known that all RIAs are fiduciaries. Some major brokerage firms forbid their representatives from becoming RIAs because they do not want representatives to have the fiduciary responsibilities that come with being one. Could a Series 7 representative who is not a RIA be deemed a fiduciary?

I posed this question to Simon, and he answered, "Absolutely! Under California case law, stockbrokers owe a fiduciary duty to their clients. (*Twomey v. Mitchum, Jones & Templeton* (1968) 262 Cal.App.2d 690.) The relationship between a broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal, which duty embraces the obligation to render a full and fair disclosure to the principal of all facts which materially affect his rights and interests. When there is a duty to disclose, the disclosure must be full and complete and any material concealment or misrepresentation amounts to fraud." (*Hobbs v. Bateman Eichler Hill & Richards* (1985) 164 Cal.App.3d 174.)

But what if the client is sophisticated? Are you relieved of this fiduciary burden? No. The relationship between a stockbroker and his customer is fiduciary in nature and the duty is owed to a customer who is both sophisticated and unsophisticated, according to *Duffy v. Cavalier* (1989) 215 Cal.App.3d 1517.

Moreover, the NASD holds that stockbrokers are fiduciaries--if for no other reason than because of the fiduciary duty to "know your customer." This requires knowing everything relevant about the customer's account, including the amount that the customer is willing to "lose" in his or her account. In addition, if the customer believed that he or she was making money, but the stockbroker knew that the client was losing money, the stockbroker would have a duty to inform the customer.

In addition, fiduciary duty (even for a Series 7 representative) requires a full and complete accounting to the customer. Fiduciary duty requires disclosure of all relevant facts about the customer's account. Fiduciary duty requires learning everything relevant to the customer's account and his or her risk tolerance and then rendering appropriate advice.

Advice vs. Education

Some readers of this column have written in to state that they only provide "education" and do not render "advice." This could be a crucial distinction. Under the Employee Retirement Income Security Act (ERISA), whenever an investment professional is deemed to be giving investment "advice" as opposed to providing investment "education," he or she attains fiduciary status.

How can you make the distinction? According to Simon, it is education to describe the attributes of asset classes. But when recommendations are made as to what particular asset classes to invest in, you are rendering advice.

If you call yourself a "trusted advisor" or a "financial advisor," you cannot claim you are merely providing education or merely clearing transactions. The first key word here is "advisor." The second is "trusted." If you use the words "trusted," "trust," or "advisor" in any of your ads, brochures, seminars, or on your Web site, you have probably entered into a fiduciary relationship with your clients. Review the two definitions of "fiduciary" given above.

The Good News

The good news is that you do *not* have to outperform the market to fulfill your fiduciary responsibilities. You do not have to make your clients rich to fulfill your fiduciary responsibilities. This is a crucial point that is often overlooked in all of the articles and books on fiduciary responsibility.

According to Simon, evidence of a breach of fiduciary duty is often based on whether or not the investment advisor has a rational investment process in place. He says that "prudence is determined by *fiduciary conduct not portfolio performance*." That is, prudence is determined not by actual portfolio results, but by the soundness of the decision-making that led to those results.

More good news: The fact that a portfolio declined in value has no bearing on whether the investment conduct of the fiduciary was prudent or imprudent. An advisor and his or her clients could have made a fortune by investing solely in Internet and high-technology stocks in 1998 and 1999. Were those prudently designed portfolios? No.

However, remember that it is usually poor performance of a portfolio that triggers lawsuits. If your clients have lost a significant amount of money over the past three years, make certain that you can defend and explain your investment process. Simon explains, "If you cannot adequately defend your investment process, investment performance is *then* used in affixing damages."

Further, you cannot blame the poor performance of your investment recommendations on "the market" or on the "unpredictability" of the market. Simon says, "It is impermissible to find a fiduciary prudent solely because he claims the declines in the value of the stock market during 2000, 2001, and 2002 were unpredictable."

If the weatherman says it will be sunny and warm on the day of our outdoor wedding and if it rains all over us, some people will blame the weatherman. Certain investors behave in the same way. It is essential that you create realistic expectations.

More good news: You can use risk-management techniques to protect your clients' portfolios and to protect your practice. According to Simon, these techniques include basic diversification, collars (selling calls and buying puts), and stop-loss orders. Simon says that such defensive techniques are in accord with prudent fiduciary investing and are an "antidote to uncertainty." Focusing on investments just because you think they will outperform is asking for trouble. "Portfolio investments are imprudent per se if the sole justification for making them is the potential for higher returns," Simon says.

The Problem with High-Commission Products

An advisor who consistently puts people in high-commission products such as certain life insurance and annuities could be breaching his or her fiduciary duty. Under the Prudent Investor Act, the trustee may incur only "appropriate and reasonable" costs. ERISA has a similar requirement. (Section 404(a)(1)(A)(ii) of ERISA.) Any fees and expenses paid by qualified retirement plans must be reasonable relative to the level and quality of services rendered by service providers. After careful evaluation during the selection stage, the plan's fees and expenses must be monitored to ensure that they continue to be reasonable.

In addition, the NASD raised a ruckus earlier this year about commission breakpoints in its Notice to Members 02-85. Protect your practice and your reputation by using commission breakpoints intelligently.

If you charge your clients high commissions, you may be vulnerable to charges of breach of fiduciary duty--especially if those clients have previously stated they wish to avoid high commissions or fees.

The standards are being raised in the financial-planning profession. Do not be discouraged by these developments. If you are a regular reader of this site, you know that it is relatively easy to build a large, highly profitable practice if you have mastered modern marketing techniques. The challenge for many advisors today is how to protect and grow your net worth now that certain attorneys have set their sights on the deep pockets of successful financial advisors.

My wish for you is that you will be able to build a substantial net worth and to keep it through your understanding of fiduciary duty. I spend a great deal of my time coaching advisors on how to do seminars. One of the points I have them make in seminars to prospects is, "Unlike many stockbrokers, I am a fiduciary. I am required by law to always do what is in your best interest."

This makes prospects much more comfortable with you and leads to many more appointments and to more prospects becoming clients. Used properly, the fact that you are a fiduciary can give you a powerful marketing and practice-building advantage.

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Dr. Moine has worked with financial planners, stockbrokers, mutual fund companies, brokerage firms, and wholesalers around the world. To receive information on his coaching and consulting work, write to DrMoine@aol.com and request a free copy of his report "How I Help Financial Advisors Rapidly Build Highly Profitable Practices."

Dr. Moine is co-author of the new, best-selling book *Ultimate Selling Power: How to Create and Enjoy a Multi-million Dollar Sales Career*.