WE
FAMILY OFFICES
BUILDING YOUR WEALTH ENTERPRISE.

Cutting Through the Clutter!
How Independent is Your Advisor?

In this series of white papers, we have discussed how a family can "cut through the clutter" to first determine what kind of financial service provider they are working with, and second, what are the implications of working with each type. In general, there are three types of advisors: Manufacturers, Distributors, or Independent, Fee-only Fiduciaries (IFOF). Depending on what your family is looking for, each type of advisor probably has a place in a family's roster of financial service providers, but it's important to be aware there are significant implications to working with each type.

The primary difference a family should keep in mind is that Manufacturers and Distributors are focused primarily on SELLING financial products and services and Fee-Only Fiduciaries are focused primarily on giving clients advice about BUYING financial products and services.

The difference between buying and selling is the crucial point of distinction clients should focus on because an advisor's economic interest in selling financial products and services is almost always the root of potential or actual conflicts of interest between advisors and clients.

In this third paper in the series, we focus on specific ways a family can determine whether a particular advisor:

(1) has a fiduciary duty to act in their best interests;
(2) is independent or is affiliated with any Manufacturer or Distributor; and
(3) is compensated based on selling particular financial products and services.

If it is important to your family to be advised by an Independent, Fee-Only Fiduciary, it is essential to assess the firms you are considering against each of these three criteria.

// IS YOUR FINANCIAL ADVISOR A FIDUCIARY?

Certain financial advisors have a legal duty to act in your best interests. Others do not. How can you tell the difference? Registered investment advisers are bound to a fiduciary standard that stems from the U.S. securities laws, in particular, the Investment Advisers Act of 1940. Registered advisers can be regulated by the SEC or state regulatory entities. These advisers' fiduciary duties require them to act in the best interests of their clients and to place the clients' interests above their own, at all times. Further, a fiduciary adviser also has a legal duty of loyalty to their clients.

By contrast, broker-dealers are permitted to make investment recommendations as long as they are "suitable" for their customers. This means that, instead of having to place his or her interests after those of the client, a broker-dealer is required to have only a reasonable belief that an investment recommendation is suitable, given the client's financial needs, objectives and unique circumstances. **Most importantly, a broker's duty of loyalty is to the broker-dealer firm he or she works for, not the customer.**

// LOOK IT UP

How can you tell the difference between advisors? You can look at the relevant account agreement governing the relationship with your advisor to see whether it is a brokerage account agreement or an investment advisory agreement. You can also look up your advisor on the Financial Industry Regulatory Authority site to see whether he or she is a "registered representative of a broker-dealer" (held to a suitability standard) or a "representative of an investment adviser" (held to a fiduciary standard). To look up your advisor, go to: http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/ You can also see whether the firm your advisor works for is a registered investment adviser (i.e., a fiduciary) by seeing if the advisor is listed on the U.S. Securities and Exchange Commission's investment adviser website: http://www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx

Finally, you can ask your advisor: Do you have a fiduciary obligation to act in my best interests or are your recommendations subject to a suitability standard? If they tell you they just have to make sure investments are suitable for you, ask them how you can be sure you are getting cost effective, independent investment recommendations that are in your best interests, and not in the interest of the advisor, their firm, or its affiliates.

One really important thing to keep in mind is that the advisers' fiduciary standard requires that an adviser must act in your best interests OR fully disclose it is not doing so. This is a big caveat, and in many instances the disclosure exception has swallowed the “best interests” rule. In practice, this means that there are many advisors (or companies affiliated with them) who by law owe a fiduciary duty to their clients but whose actual business practices are rife with potential or actual conflicts of interest at their clients’ expense. Unfortunately, so long as these actual and potential conflicts of interest are properly disclosed to the clients – typically in the “fine print” in client documents, and often in vague, general language - an adviser can represent itself as a fiduciary acting consistent with its fiduciary obligations.

One way to thoroughly check for conflicts of interest is to read the firm’s Form ADV filed with the US Securities & Exchange Commission. The next paper in this series, How To Read A Registered Independent Adviser’s Form ADV gives direction on how to get started.

// IS YOUR FINANCIAL ADVISOR INDEPENDENT?

If you custody your assets at a global financial company, it is likely to have numerous affiliates that provide a range of services including, banking, brokerage, trust services, investment advisory, and investment banking. These companies often make money by “cross-selling” their various affiliates’ products and services to their clients. Their business model is sales-driven. The interrelationships in these companies create potential or actual conflicts between the companies and their clients whose best interests are often not to buy additional financial products and services priced higher than clients could pay elsewhere, or that they simply don’t need.

Often, these kinds of conflicts are disclosed only in general terms in the “small print” of the lengthy account agreements clients sign to establish their relationships with their custodian. These conflicts may or may not be specifically discussed when particular investment or financial products are offered to a client.

An independent financial advisor, i.e., one that is not part of a larger financial services company, does not have this kind of sales-focused business model. An independent advisor will tend to be more open and fundamentals-driven, and more focused on the client’s needs and goals when deciding which money managers to recommends to clients, or which brokerage firm the client should execute trades with. Further, if the independent advisor is also a fiduciary, it is more likely to focus on serving the interests of its clients, rather than the interests of its affiliates.

// IS THE ADVISOR COMPENSATED BASED ON SALES OF A PARTICULAR PRODUCT?

If, in addition to being (1) a fiduciary, and (2) independent, your advisor does not receive compensation from selling particular investment products and services, then it is significantly more likely they will provide you with investment advice that is in your best interests, period.

Many advisors have a financial interest in investment products you purchase at their recommendation. Some advisors, such as brokers, are paid by sales or transaction-based commissions. Others, such as mutual fund or hedge fund managers, are paid fees from the funds clients invest with them. In addition to these more direct sales-based compensation arrangements, some advisors also have agreements with affiliated or third-party investment managers to sell their products – often to the exclusion of other funds, regardless of how favorably their cost and performance compare. Many advisors have multiple sources of revenue, even if they are also paid with an advisory fee.

How can you tell how your advisor is compensated?

1. Look at the account or other agreement you signed with them. The agreement should contain disclosures about all of the ways the advisor is paid.
2. If the advisor is a registered investment adviser, their primary disclosure document, the Form ADV Brochure, at Item 5, contains information about the various ways they can be compensated.
3. Ask your advisor the following questions:

   How is your firm compensated?
   (i.e., a percentage of assets under management or flat retainer).

   Do you receive fees, commissions or other revenue from anyone except clients, and are you affiliated with another firm?

// CONCLUSION

Investors can be well served by a variety of kinds of financial advisors – manufacturers, distributors, or IFOFs. As long as investors understand the legal obligations, business models and compensation arrangements of each of their advisors, they can properly assess the potential costs and biases of the advice and recommendations they get from each one. It is imperative to accurately weigh costs and advantages, and receive the benefit of advice that is closely aligned with their financial interests.