ROOF ADVISORY GROUP, INC.™
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

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# *Advisory News Brief*

*Part of Roof Advisory Group's ongoing series of updates designed to keep investors informed about news & events impacting the financial marketplace.*

## Caveat Emptor

Buyer beware. Never have these words been more appropriate than for individuals seeking high-quality, independent financial planning or investment advice. Current regulations allow many salespeople (stockbrokers, bankers, insurance and mutual fund agents, etc.) to hold themselves out to the public as 'trusted financial advisors' – you've seen the commercials on television. Just as troubling is the fact that the regulatory watchdog responsible for 'protecting investors and maintaining the integrity of the securities markets', the U.S. Securities & Exchange Commission (SEC), is helping create this consumer confusion.

On April 6, 2005 the SEC unanimously voted to make the so-called 'Merrill Lynch' rule permanent. The rule essentially allows brokers to promote themselves as 'investment advisors' without being held to the same fiduciary standards as a Registered Investment Advisor (RIA) and without complying with the Investor Advisors Act of 1940, regulations specifically created to protect the public. Here's the loophole; as long as the 'advice' given is deemed to be 'solely incidental' to the sales function that the broker is performing, the rule says there is no need to comply with all of the pesky regulations that true RIAs need to follow.

The conflict is apparent. While being structured and motivated to sell commission-based products, most brokerage/financial service firm's marketing campaigns blatantly boast of their prowess in providing superior investment strategies, investment advice, and even retirement and estate planning. Rather than being 'incidental', advisory functions are positioned in the public perception as a primary objective.

## Whose Interests Are Really Being Protected?

The story began to unfold in 1999 when Merrill Lynch introduced a new program called Unlimited Advantage. The concept was to charge a flat percentage of assets held in a brokerage account in exchange for the unlimited trading of securities and investment 'advice.' Regulations that governed providing investment advice to the public were clearly defined in provisions of Investor Advisors Act of 1940 that pertain to Registered Investment Advisors. However, the SEC and its 1999 chairman, Arthur Levitt, entertained this move away from the normal brokerage transaction model because of the unprecedented number of client complaints pertaining to excessive trading and the fact that brokerage firms were feeling competitive pressures to provide 'managed' account alternatives.

The only problem was that Merrill Lynch did not want its brokers to be subject to the same rules, regulations and standards to which RIAs must adhere. Brokers took issue with the disclosure of potential conflicts of interest, the fees charged, the services provided, and disciplinary history that RIAs have always been required to provide to their clients. Unfortunately the SEC was so anxious to move away from the traditional brokerage models that they decided to provide an exemption for Merrill Lynch's new program. The exemption remained in force for five years, on a temporary basis, until this April. Now it is a permanent part of the investment community's regulatory landscape.

## Fiduciary Standards?

The SEC's new regulation permits virtually anybody to hold him or herself out as an 'advisor' and investors are left to ferret out exactly what regulations and standards apply, as well as whether a fiduciary relationship exists or not. The difference is significant. Fiduciary status is conveyed on individuals and organizations that manage assets for the benefit of another or act in a professional capacity of trust and render comprehensive and continuous advice. How is an investor supposed to determine who is truly a broker (a salesperson whose advice is solely incidental to selling a commission-driven product) and who is truly an advisor (a fiduciary whose interests are solely aligned with their client)?

The SEC's proposed solution to this is to require that non-advisors provide a disclosure statement that reads "your account is a brokerage account and not an advisory account…our interests may not always be the same as yours". This is hardly a disclosure on par with the comprehensive disclosure requirements used by RIAs via Form ADV Part II, a standardized disclosure that contains detailed information regarding the RIA.

### A Uniform Standard

The Financial Planning Association is calling for the SEC to require uniform standards for all advisors and to make assurances that all advisors are placing their client's needs ahead of their own. Additionally, the SEC seeks to require that all advisors be fully qualified to provide financial advice – not just to sell products. These are not unreasonable expectations.

James A. Barnash, the Financial Planning Association president, says "The rule provides inadequate protection to consumers. The SEC erred in adopting a defective rule. The consumer-warning label could easily be ignored or glossed over by investors who are already overwhelmed with numerous account agreements and other disclosure documents."

### Different Strokes

The concern is not that one method of interacting with investors is correct and one is incorrect. Fee-only and independent advice is ideal for many investors, while purchasing products from a commissioned sales force works well for others. The issue is that all investors should know exactly what they are getting or not getting, how the professionals they deal with are compensated and what potential conflicts of interest exist from the very beginning of the relationship.

### Let's Be Honest Here

Members of the financial services industry (or the advertising firms they hire) have created more labels for themselves than it is reasonably possible to track (financial advisor, financial consultant, investment advisor, wealth manager, etc.). Most of these terms have little to do with the true motivation or daily activities of the people who put them on a business card. There does not seem to be any problem with the public determining who is/is not a CPA or attorney and knowing exactly what is required for that professional to hold themselves out as such. Why should dealing with a financial advisor be any different?

Until some clearly defined standards for the terms that are thrown around the financial services industry are created, and their usage enforced, the investing public will remain at a disadvantage. The issue goes beyond knowing who to trust, the issue is that most consumers do not even realize there is a difference. At present, a simplest litmus test can be applied, ask an advisor if he/she is indeed a fiduciary that must comply with the Investment Advisors Act of 1940 and for a copy of their Form ADV Part II.

### The Roof Advisory Group Advantage

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