



Impact on Brokerage Firms of a Fiduciary Standard

By Peter Keuls
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The Dodd-Frank Wall Street Reform and Consumer Protection Act is likely to usher in a transformation of the wealth management industry with implications not only for the brokerage firms that will be most affected by new regulations, but also for private banks and investment advisors who already operate under a fiduciary standard of care. Congress has charged the SEC with the responsibility and authority to create a single fiduciary standard covering brokers, who were previously only held to a suitability standard, and investment advisors who already work to a fiduciary standard of care. While the final shape of this SEC rule-making will determine how brokers and investment advisors will be impacted, we can be sure that the changes will be far reaching and impact almost every element of brokerage firms' business models, from product management, client management, execution and FA compensation.

Fiduciary Standard Definition

The fiduciary's responsibility is to put clients interests first, ahead of all else and always act for the benefit of the client. Taken to its logical extreme, this would require fiduciaries to forsake all compensation and profits which directly or indirectly come at the expense of their clients. Of course, if this was truly required, there would not be any but a few very charitable investment advisors. So, where conflicts are unavoidable, such as in matters of compensation, it is the fiduciary's responsibility to fully disclose this conflict and enable the client to look after their own interests in this regard. Therein lies the critical issue underlying the impact of the SEC's decisions regarding a new fiduciary standard – to what degree will foreseeable conflicts (of which there are many) be prohibited versus merely disclosed. Nevertheless, even full disclosure

The five core principles of the Fiduciary Standard established as part of the Advisers Act of 1940 are to:

1. Put the client's best interests first;
2. Act with prudence; that is, with the skill, care, diligence and good judgment of a professional;
3. Do not mislead clients; provide conspicuous, full and fair disclosure of all important facts;
4. Avoid conflicts of interest;
5. Fully disclose and fairly manage, in the client's favor, unavoidable conflicts.

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will be unprecedented in many respects and would foster significant change in pricing, pay practices and even business models.

Conflicts to Manage

Brokerage business models currently feature many potential conflicts of interest that will come under scrutiny with a new fiduciary standard of care.

1. **Commissions** - The Dodd-Frank Act explicitly permits commission-based compensation despite the conflicts of interest it can engender. While this has the benefit of giving clients the ability to choose a pricing arrangement with their advisor that is best for them and preserves a fundamental element of the sales culture of brokerage firms, it may in the end, be an unwanted authority. Firms may decide that commissions coupled with steep, retroactive grid rates create too powerful an incentive for FAs to execute transactions that are more in their own interests than the client's and that the associated legal liabilities under a fiduciary standard of care are simply too great.
2. **Recruitment compensation** – It is common for Financial Advisors to receive substantial sums of up-front and contingent compensation for switching firms and bringing along their book of business. However, as a fiduciary at their old firm and new, the Financial Advisor's responsibility is to ensure that if encouraging their client to move with them from one firm to another, that this is truly best for the client. The conflict of interest that these payments create, particularly, but not exclusively the contingent compensation, at a minimum will require disclosure to a client. Since these payments have the potential to amount to tens of thousands of dollars per client, their disclosure is certainly going to raise questions from clients as to why their FA is reaping all of the rewards and not themselves, since it is their money that is in play. In fact, it might behoove firms to offer recruitment bonuses to clients at the expense of FAs. A fiduciary standard, if it doesn't prohibit or severely limit FA recruitment bonuses, will have a chilling effect on FA mobility.
3. **Retrocession** – Brokerage firms typically receive substantial payments from third party fund managers. These payments provide mutual fund complexes with access to the brokerage firm's FAs and clients as well as compensation for record-keeping and other administrative services the brokerage firm may provide.

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These income streams are large enough that they are an important part of the economics of brokerage firms. However, these payments create a substantial incentive for firms to offer the products from asset managers that have been most generous in these payments rather than those that have the lowest expense ratios and best performance. At a minimum, this conflict will need to be disclosed. It is possible that these payments will be limited and scaled to the value of the services that brokerage firms really do provide these fund managers.

4. Principal transactions and IPOs – Equity and fixed income transactions where the firm acts as a principal or owner of these securities have an innate conflict with the client since the principals' objective is to get the best price for themselves and fiduciary's objective is to get the best price for the client. All mark-ups will need to be disclosed to clients so that clients can see the profit the firm is making. It will also be best practice for FAs to always seek best execution from a range of dealers, not just their own firm. Similarly, a conflict of interest arises with IPOs where the firm seeks to achieve the highest possible price for itself and its corporate client, but has an obligation as a fiduciary to retail investors to get the lowest possible price. This might require retail investors to be excluded from IPOs.

In order to manage these conflicts, brokerage firms will need to make significant and costly improvements to their processes.

1. Relationship Management Processes - Client profiling, planning, investment selection, transaction justification, portfolio and client reviews will need to be much more rigorous and more consistently applied than they currently are at many firms.
2. Product management – As a fiduciary, brokerage firms will need to ensure they provide clients with access to the best possible range of products without bias. Limited product ranges that feature proprietary product provide only the appearance of choice.
3. Execution – Firms will need to ensure that all transactions are executed at the best available pricing, especially for principal business.
4. Disclosure – Client statements and confirmations will require complete client disclosure of all broker compensation related to a transaction and firm sources of revenue along with presentation of alternative pricing arrangements.



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5. Staffing – Firms will need to decide what is a responsible level of FA and Sales Assistant coverage given the firm’s duty of care and may need to implement client load limits.
6. Compensation – Branch management and FA incentives plans will need to be reviewed to ensure that incentives minimize conflicts of interest with the client and support the fiduciary process.

These investments will be significant and, unless FA compensation and overhead costs are reduced, will pressure brokerage firm margins that have already been squeezed to all-time lows. To the extent that cost savings cannot be achieved elsewhere, the cost to clients will have to increase, potentially pricing small investors out of the advisory market.

Firms that are most likely to have the capacity to make these investments quickly and efficiently are the largest firms. Smaller firms will be doubly disadvantaged because it will be more difficult for them to grow to the scale to compete effectively without mergers or acquisitions since the fiduciary standard will make FA recruitment more difficult. However, there are very few sizable firms left that, when combined, can achieve the scale of the four national firms, limiting the value of an acquisition growth strategy.

The Dodd-Frank Act will create a transformation of the brokerage industry at least as great as the deregulation of brokerage commissions did in the 1970s. Future notes will explore in more detail how Financial Advisor compensation may change and the impacts on other industry participants such as private banks.

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