

Broker-Dealers as Fiduciaries?

How the SEC Staff's Study Could Raise the Bar for Investment Advice

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The financial crisis and Section 913 of the Dodd-Frank legislation has forced a reexamination of the fiduciary responsibilities of advisors and brokers.

In January 2011, the SEC staff Study on Investment RIAs and Broker-Dealers (hereafter referred to as the "SEC Staff Study") recommended that the market adopt a single fiduciary standard of care for personalized financial advice.

In response to the financial crisis, the SEC staff study has recommended holding broker-dealers (BDs) to a fiduciary standard, as opposed to the long-standing "suitability" guidelines. While raising the standard has obvious ramifications in terms of BD conduct, perhaps less obvious is the fact that from client on-boarding to fee arrangements and investment management decisions, nearly every aspect of Financial Advisor day-to-day activities of both BDs and Registered Investment Advisors (RIAs) will be significantly scrutinized. The use of advancements in wealth management technology can assist Financial Advisors of both BDs and RIAs in adhering to the new fiduciary standard.

Background

For over 70 years, RIAs and BDs have competed alongside each

other, yet played by a very different set of rules. RIAs have historically been regulated either by the SEC or state regulators, whereas BDs have come under joint oversight of the SEC and FINRA (formerly NASD). More importantly, RIAs have been governed by a fiduciary standard, whereas BDs have been held to a less stringent "suitability" standard. As the distinction between these two standards is much more than a mere technicality, we further explore this difference below.

Registered Investment Advisors: Fiduciary Standard

RIAs are governed by a fiduciary standard. The SEC Staff Study further explains:

*"An investment advisor is a fiduciary whose duty is to serve **the best***

interests of its clients, including an obligation not to subordinate clients' interests to its own. Included in the fiduciary standard are the duties of loyalty and care."

RIAs also have a duty to manage conflicts of interest. An RIA that has a material conflict of interest must either eliminate that conflict or fully disclose to its clients all material facts relating to the conflict.

One such potential conflict of interest relates to fees. Although there may be some exceptions, RIAs typically structure their charges as an asset-based fee. Whereas commission-based fees provide an incentive to execute trades that may not be in the client's best interest, asset-based fees eliminate this conflict of interest and provide an alignment of goals: If the client's portfolio falls in value, so will the RIA's fees.

Broker-Dealers: Suitability Standard

In contrast to RIAs, BDs must meet a suitability standard, generally considered more relaxed than the fiduciary standard. Hailing from a time when brokers – as the name suggests – were viewed less as “advisors” and more as agents facilitating client transactions, according to the SEC staff study, the standard requires only that:

“In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security

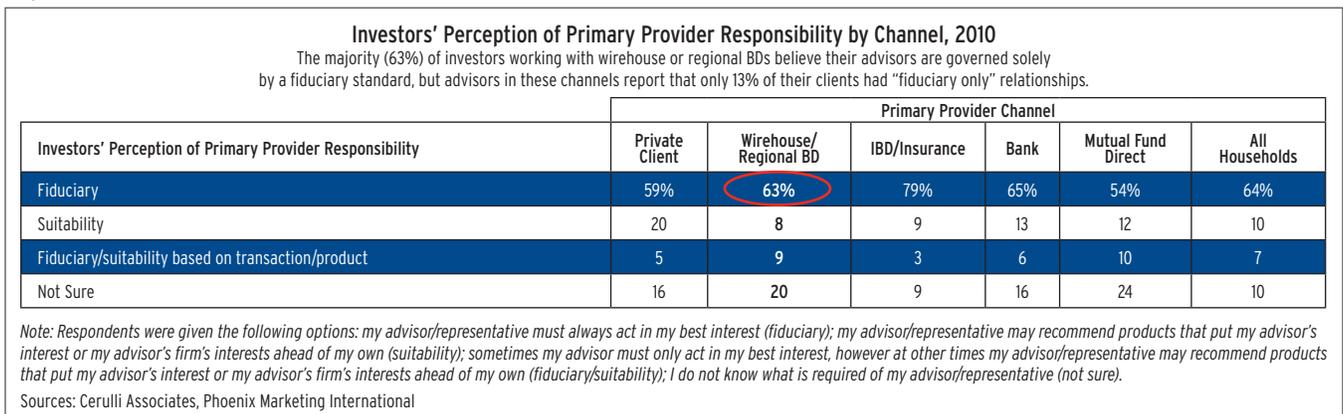
holdings and as to his financial situation and needs.”

Critics of the suitability standard have argued that it reads like a minimum threshold – insisting that the investment be adequate for the investor, but that the quality of the recommendation stops short of the “higher standard of care” proscribed by fiduciary relationships. Importantly, while BDs are required to make certain disclosures, much of the burden under this regimen falls on the investor to ask the right questions of his broker. Lastly, BDs are generally not required to consider the fees, costs or tax efficiency of an investment product, and given their transactional history, are more likely than RIAs to collect fees through commission arrangements.

Recommended Changes

As part of the sweeping reforms ushered in by the Dodd-Frank Act, the SEC was required to conduct a study regarding the obligations of BDs vis-à-vis RIAs. Among other conclusions, the study found that “many investors are confused by the standards of care that apply to RIAs and BDs.” Research from Cerulli Associates confirms this customer conclusion: Sixty-three percent of investors who work with wirehouse and regional BDs believe they receive advice under a fiduciary standard, when in fact, only 13% of BD relationships are reported as fiduciary in nature.

Figure 1



Furthermore, the SEC staff study recommended in January 2011 that the market adopt a single uniform fiduciary standard of care for personalized financial advice. The study further states that “retail investors should not have to parse through legal distinctions to determine” the type of advice they are entitled to receive. Instead, retail customers should be protected uniformly when receiving personalized investment advice about securities regardless of whether they choose to work with an investment advisor or a BD.” At the same time, the study notes that retail investors should “continue to have access to the various fee structures, account options and types of advice that investment advisors and broker-dealers provide.”

Impact of Potential Changes

While the SEC staff study is not a formal proposed rule, such a uniform standard, if adopted, may place a significantly increased demand on BDs. Today, the connection between client objectives, what the BD

recommends and the solution that is actually implemented is often weak. Under a fiduciary standard, BDs may need to make significant enhancements to their operating model. Improved wealth management technology is vital to bridging any gap between the current suitability standard and fiduciary guidelines, not only for BDs under proposed guidelines, but also for RIAs to effectively meet their obligations.

Interestingly, it’s not just wealth managers who recognize the importance of technology. According to George Magera, a Partner in Reed Smith LLP’s Investment Management Group, who noted the following to Citi: “Both the SEC and FINRA have recently explored using technology to assist them with conducting examinations, and the SEC recognized in the Study on Investment Advisors and Broker-Dealers that BDs may incur ongoing costs in developing or acquiring technology,” should the broker-dealer exclusion from the definition of investment advisor be eliminated.¹

Today, many BD technology platforms and, to a lesser but still significant extent, RIA platforms, may be poorly equipped to ensure that their representatives are conforming to fiduciary standards, for two reasons: i) because these systems were developed with suitability standards in mind and ii) many of the systems in use today were built on mainframe technology of the 1970s and 1980s. To meet a potentially new fiduciary standard, BDs as well as RIAs may want to consider improvements in the following main areas:

- Automatic linkage from front-to-back of investor information, risk profile, restrictions, proposed portfolio and portfolio execution
- Aggregation across all investment vehicle types
- Household reporting AND rebalancing across multiple account types (e.g., brokerage, retirement, trust)
- Tax optimization at the individual (tax return) level

Each of these themes is explored in detail below.

¹See SEC Study on Enhancing Investment Adviser Examinations (pp. 15, 26, 27) and Study on Investment Advisors and Broker-Dealers; see also March 1, 2010 FINRA letter (<http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p121004.pdf>).

Building Automatic Linkage: from Front to Back

While the suitability standard does generally require BDs to make investment recommendations that are consistent with the interests of its customers, that standard is usually enforced at the point of sale. BDs are not required to have a continuing duty of care or loyalty to a retail customer after providing personalized investment advice. As a result, whether driven by the suitability standard or a historically transactional culture, BDs generally lack automatic linkages between the different components of their services to investors. As indicated in figure 2 below, multiple disparate systems typically are used to deliver various components of services to the investor. But disparate systems could create a host of difficulties:

1. Information is either absent or must be manually reentered from system

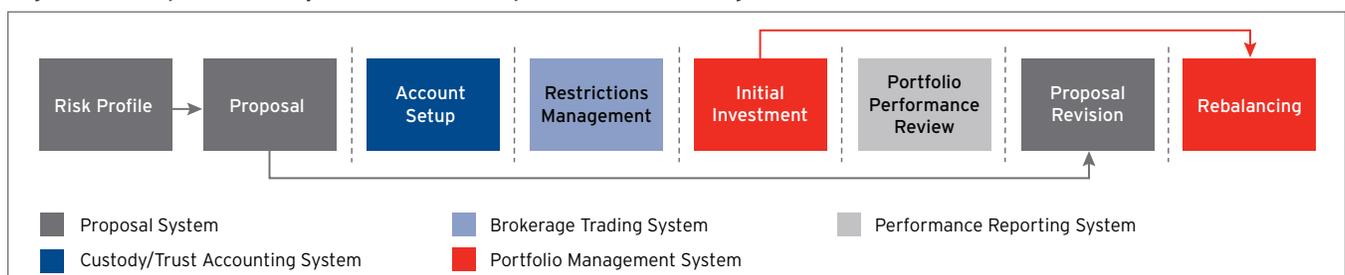
to system, resulting in, at a minimum, significant potential for error.

2. Significant differences exist between abstract investments in a proposal on the one hand and portfolio execution of specific investment vehicles on the other, despite these investments meeting suitability standards.
3. Failure to provide for automation of updated information associated with investors' changing requirements, e.g., cash needs, retirement, death, divorce, inheritance, restriction modifications, etc.
4. Lack of automated workflow from risk assessment through account on-boarding, portfolio implementation, performance review, reassessment of results and portfolio modification (rebalancing).

RIAs, on the other hand, are expected to not only assess clients' objectives at the initiation of the relationship,

but to update these objectives either on an annual basis, or as clients' circumstances change (e.g., due to an inheritance). Skeptics may wonder if this is really a big deal – can't the BD just periodically ask clients to update their objectives? While this might be a step in the right direction, it's hardly a foolproof initiative due to manual processes associated with portfolio delivery. Such ad hoc steps are largely manual and may suffer similar systematic deficiencies between the risk/proposal systems used and portfolio execution/evaluation. In fact, while most RIAs deliver more expansive financial planning capabilities (see figure 2 below – Proposal System), for portfolio execution they typically utilize clearing services from third-party custodians with less integrated solutions and more limited infrastructure than wirehouse BDs.

Figure 2 – Disparate BD Systems Fail to Adapt with Client Change



As a best practice, RIAs not only ask clients to outline their objectives, but also work with clients to develop a detailed investment policy statement. Although an investment policy statement usually does not trigger automatic rebalancing decisions, it does lay out a road map for decision making in much more detail than a simple risk tolerance questionnaire frequently used by BDs. Effective wealth management platforms can automate investment policy guidelines so that client objectives, investment restrictions and tax circumstances can be considered on the fly, before a financial advisor executes a transaction.

Aggregation: Considering Asset Location, as Well as Allocation

In order to fulfill fiduciary duties, RIAs and BDs need to take an aggregate view of investors' assets. Whereas the original Prudent Man rule emphasized preservation of capital and the evaluation of individual investments against this standard, the Prudent Investor proscribed evaluating investments in the context of a broader portfolio. Under the

later adopted Prudent Investor rule, a fiduciary would not be held liable for individual investment losses, so long as the investment, at the time of acquisition, is consistent with the overall portfolio objectives of the account.

The local application of the prudent investor rule rests on the delivery of three components:

1. Access to all products within and across accounts
2. Views and reporting of all accounts across multiple BD, Bank, Trust and retirement plans
3. Tax management and optimization at the household level

Product Access

Such portfolio-based considerations have become all the more important, given the vast array of investment products and services available to retail investors today. Exchange-Traded Funds (ETFs) or hedge funds that short securities might, in isolation, be perceived as risky, yet could reduce overall portfolio risk. Moreover, each of these products vary in terms of liquidity and transparency, with ETFs traded and priced intraday,

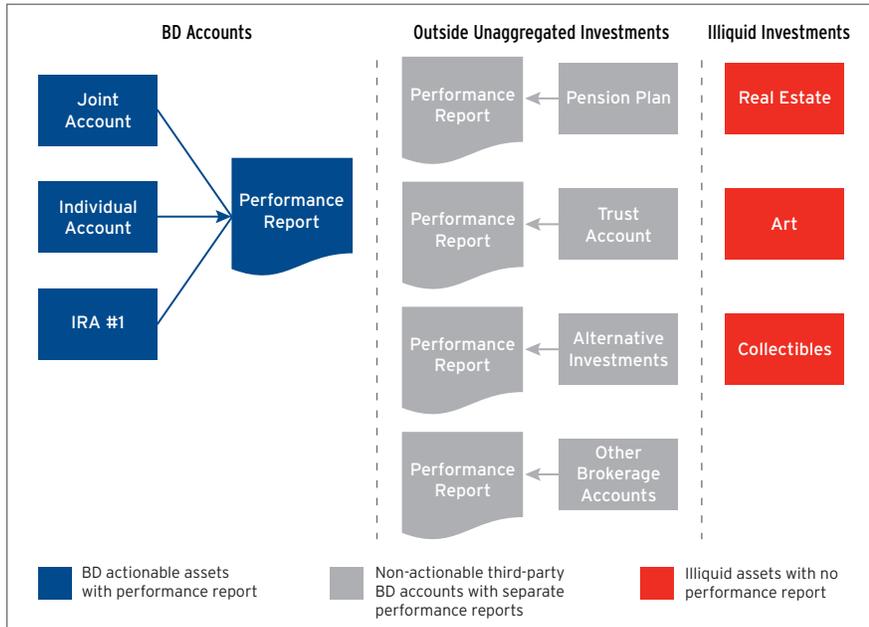
and hedge funds offering only periodic redemptions and visibility. Some BDs have delivered investment products in silos – a mutual fund wrap platform for smaller accounts, and a hedge fund platform for high net worth clients, for example.

Though many BDs have attempted to offer unified managed accounts (or vehicle-agnostic relationships), the technology that weaves these products together is often lacking. In essence, the product silos are defined by technological limitations, not investor requirements. This limitation results in an artificial assemblage of investor accounts multiplying, like Star Trek Tribbles, to accommodate each new product and platform sold. This only further undermines achieving a fiduciary standard.

Aggregated Reporting

In some cases, an aggregated view across investment products in an investor report at month or quarter end is available. Typically, these tools are BD specific and include only investor accounts at the specific BD (see figure 3 on next page). While some third-party aggregation tools are available for accounts at multiple

Figure 3 – Unaggregated Performance Reporting



destinations, they rely on screen scraping or investor-controlled uploads of external statements. Such information may be so untimely or inaccurate as to adversely affect

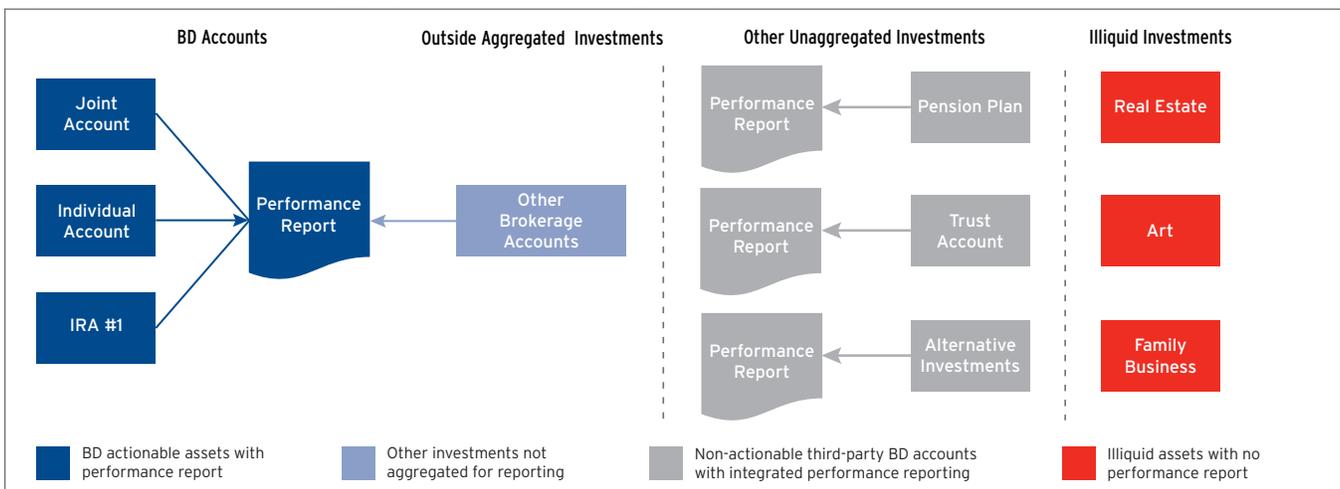
certain functions (e.g., trading, analytics) and the information may be relegated to a reporting display of other brokerage accounts. Missing completely from any current

third-party aggregation tools are the inclusion of non-brokerage accounts (trust, bank), retirement plan assets, insurance policy values, alternative investments and illiquid investments (e.g., real estate, art) (see figure 4).

Aggregated Rebalancing

A more universal limitation of both BD and RIA systems is that they tend to lack front-end tools to place trades and rebalance portfolios across multiple investor accounts; many current systems are only backward looking. The main differentiator of RIAs is frequently the extensive use of Financial Planning tools to examine an investor’s household net worth and investable assets. These let RIAs produce an investment

Figure 4 – Current Level of Aggregated Performance Reporting



policy statement (IPS) governing things such as asset allocation and proscribed investments (restrictions). BDs typically use a risk tolerance questionnaire (RTQ) at the individual account level to assess investment time horizon and tolerance for volatility (meaning losses) in investor accounts. Both generally use a proposal, but as discussed above, these tools exist as disparate technologies. Although the investor may get a more elaborate and holistic plan with an RIA versus a more abbreviated RTQ with a BD, the result is similar. The prospective investment actions of their agent (RIA or BD) are not systematically or automatically implemented in light of recommendations of the retrospective analysis. Both BDs and RIAs must do this manually.

Householding: Delivering an Investor Holistic Solution

A final piece of the puzzle for BDs is the ability to offer unified managed householding to address a potential new fiduciary standard (and RIAs to extend that standard to active portfolio management). Citi Wealth

Management Services defines unified managed householding as being able to provide optimization across the whole investor portfolio, including multiple product vehicles within and across accounts (as described above) and all account types (personal trust, brokerage and retirement). Householding can be thought of as an extension of the unified managed account across all of the individuals and accounts of a household, or otherwise-defined family of accounts.

Deployment of a proposed portfolio, as described above, into an actual portfolio is complicated by a myriad of factors associated with household needs and frequent inability of BD and RIA systems to consider multiple accounts simultaneously, among them:

- Different specific account tax rates
- Transition management of legacy (low basis) holdings
- Cash flow needs of the investor
- Required distributions from retirement or trust accounts
- Limited liquidity of some investments in the allocation (e.g., alternatives)

- Overlap of securities in different investment manager models
- Investable assets relative to product minimums
- Portfolio drift and rebalancing cycles
- Restrictions
- Household fee discounts and accounts to be billed
- Year-round tax management versus year-end tax harvesting
- Accounts held away
- Illiquid assets (e.g., real estate)

As mentioned above, some BDs struggle to provide a cohesive view across retail, trust and retirement accounts. Indeed, accounts of different types may be registered under different subsidiaries, maintained in different accounting systems and covered by different reporting systems. The matter is only made more complex when considering accounts held away from the primary BD. While household aggregation is a challenge and sporadically delivered, it is driven by integration, connectivity, legal authority and control, all issues well understood and manageable. You either have it or you don't.

Household rebalancing, however, has been an elusive concept to both define and deliver due to the complexity identified above. Citi Wealth Management Services defines household rebalancing as the ability to:

- Hold any security type or investment product within and across all accounts in a household and not be required to open additional accounts to accommodate specific products
- Automatically schedule rebalancing at the household level by a variety of mechanisms such as: calendar, cash flow event (deposit/withdrawal), desired frequency (daily, monthly), model change and ad-hoc
- Aggregate household accounts across any accounting system (brokerage, trust) and multiple locations (e.g., brokers, banks, insurers)
- Within the household, systematically know the tax rate of each account and the available gains/losses such that tax optimization occurs throughout the year
- Understand the difference between asset allocation and asset location to maximize potential tax benefit of securities placement

- Manage overlap such that the same securities are not being bought in one account and sold in another or bought in more places than one, creating an unintended overweight position
- Automatically rebalance the household of accounts while optimizing cash flow to be applied to needs such as trust income segregation, RMD of an IRA or dollar cost averaging
- Schedule the sale of legacy holdings automatically over time (transition management) based on portfolio gain and loss matching, while using the legacy holdings as correlated substitutes

To truly deliver to the potentially new fiduciary standard, both BDs and RIAs will likely need to systematically execute against all these specific parameters of the investor across all available investor assets, thereby delivering true household management.

Conclusion

The shift from a suitability standard to a fiduciary one recommended by the SEC staff study is more than a

cosmetic change. To be sure, the gap between the BD and RIA communities has narrowed over time, as the former has adopted more use of fee-based structures, dual-registration and professional (e.g., CFA) designations. Nevertheless, the gap remains such that these potential changes could have a profound impact on business practices.

However, let's be clear – while the SEC staff study is not a proposed or final rule, any determination could take significant time to be finalized in some yet-undetermined form. That being said, should a new fiduciary standard come to pass, a shift of this magnitude will require more than the stroke of a pen, for it is not just a would-be regulatory change, but also a significant change to the day-to-day operating model of the BD community. Integrated technology, harmonizing client on-boarding, holistic management across accounts and individuals, while updating circumstances over time, is a critical component in meeting a fiduciary standard for both BDs and RIAs.

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Andrew Clipper is Head of Product Management and Development for Wealth Management Services in North America. Andy is responsible for OpenWealth, the first Unified Managed Household (UMH) platform supporting distributors of retail wealth management services such as banks, broker-dealers and insurers. OpenWealth is the winner of the 2011 and 2010 MMI Innovation of the Year, 2010 Product of the Year, 2010 ICFA Most Innovative Product and the 2009 Fund Action SMA Player of the Year. Andy has over 27 years of financial industry experience. Prior to joining Citi in 2004, Andy was the Director of Separately Managed Accounts for Evergreen Investments division of Wachovia Corporation, Eastern Divisional Sales Manager for separate accounts with Merrill Lynch Asset Management, Director of a subordinated debt lending for Merrill Lynch Business Solutions, Director of healthcare investment banking for Oppenheimer & Co., Inc., and an Equity Analyst covering the health care industry for Eberstadt Fleming.

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Benjamin Poor leads Citi's thought leadership initiative, providing market research and analysis designed to assist clients of Citi Investor Services in their strategic planning and understanding of market trends. He has over 15 years of experience researching the asset management industry, including manager due diligence, as well as retail and institutional distribution.

Prior to joining Citi, Benjamin served as Director of Cerulli Associates Institutional Asset Management Practice. His research responsibilities focused on asset management, including institutional and high net worth channels. Benjamin was the lead author of *High-Net-Worth Update*, *Global Multimanager*, *Hedge Funds: The Market for Absolute Return*, and *Institutional Products and Services* for The Cerulli Report™ series. He also frequently served as a subject matter expert at conferences and for the financial press.

Prior to joining Cerulli, Benjamin served as a Senior Manager of Investment Products and Services at Schwab Retirement Plan Services. His responsibilities included fund selection and investment reviews for defined contribution clients ranging from \$20 million to \$400 million in assets.

Prior to joining Schwab, Benjamin was a Mutual Fund Analyst at Kanon Bloch Carré, a division of RINET. His responsibilities included maintaining a proprietary database on enhancing the firm's quantitative risk-adjusted manager evaluation model.

About Citi Wealth Management Services

Citi's OpenWealth® seamlessly aggregates household-level data across wealth management platforms, investment managers and third-party custodians, and offers award-winning unified managed household capabilities for a front-to-back solution that eases key operational and administrative burdens and lets managers focus on building relationships and growing their business.

OpenWealth's advisor-controlled Unified Managed Accounts (UMA) and Unified Managed Households (UMH) capabilities offer a comprehensive holistic view for the investors' portfolios with efficiencies in portfolio construction and management:

- Easy and intuitive custom portfolio construction tools
- Models you can build to apply to multiple client accounts
- Automated proposals linking investor risk profile, restrictions and portfolio execution
- Automated household rebalancing and reporting
- Year-round tax optimization and cash flow management
- Automated transition management

Learn more about Citi OpenWealth by contacting us at openwealthinfo@citi.com or 877-682-2278.

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