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OBSERVATIONS

ComplianceMAX Financial's Monthly Investment Advisers Newsletter

May 2006

ComplianceMAX seeks to provide you with regulatory compliance services that help you remain compliant while allowing you to focus on sales and growth. ComplianceMAX publishes its **OBSERVATIONS** newsletter to provide you with:

- Notice of upcoming deadlines under current regulations
- Notice of new regulations and upcoming deadlines under those regulations
- Our perspectives on how new regulations may affect Investment Advisers

HAVE YOU HEARD?

Early Reports on SEC Audit Program

Based on several of your notifications to us (and your requests for our assistance) it is evident that the SEC is actively underway in its 2006 audit program.

The examination request list we are seeing in the 2006 inspections and that from 2005 remains mostly consistent. We have, however, begun to see variations, especially in regard to the SEC's probing regarding risk analysis and risk management. We will use exercises in the Resources workbooks to prepare you for the new approach, and you'll soon see an updated Risk Analysis Workbook in the Model Documents library.

We are finding that the Resources program workbooks are standing up well in response to the SEC's questions regarding the implementation of a compliance program. Further, we have seen an instance in which a CCO used attendance at the monthly "Webinars" to her advantage in support of her qualifications and training for her compliance role.

For tips on how to maximize the Resources Program in the context of your own SEC or State audit, we invite you to contact your Resources Consultant.

Observations' Guest Author Series

I am very pleased to present our guest author for the month of May:

W. Scott Simon, J.D., CFP®, AIFA®, is a principal with Prudent Investor Advisors, LLC (www.prudentllc.com), a registered investment advisory firm in Chico, CA. He has authored two books, including *The Prudent Investor Act: A Guide to Understanding*, and a number of articles. Mr. Simon also writes a monthly column for Morningstar on fiduciary investment issues called "Fiduciary Focus" and a column for the *Journal of Pension Benefits* on the same subject. He is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule) and is a consultant and expert witness in the area of modern prudent fiduciary investing. Mr. Simon, a member of the State Bar of California, can be contacted at wssimon@prudentllc.com.

The Fiduciary Duties of a Registered Investment Adviser
By W. Scott Simon, J.D., CFP®, AIFA®,

Section 202(a)(11) of the federal Investment Advisers Act of 1940 ("1940 Advisers Act") defines an "investment adviser" as: "…any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities…"

This definition constitutes that of a "registered investment adviser" or "RIA." RIAs that have $25 million or more under management must be registered with the U.S. Securities and Exchange Commission ("SEC") while those with less than that amount under management are subject to registration by their respective state securities commissioner(s).

While it is commonly acknowledged that an RIA is a "fiduciary," that term actually never appears in the text of the 1940 Advisers Act or in any of its revisions. In the case of *S.E.C. v. Capital Gains Research Bureau, Inc.* (375 U.S. 180 (1963)), however, the United States Supreme Court made clear that the 1940 Advisers Act "reflects a congressional recognition of the delicate *fiduciary nature of an investment advisory relationship*, as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested." (Emphasis added.) Further, an RIA owes its clients a duty of "utmost good faith, and full and fair disclosure of all material facts" as well as an affirmative obligation "to employ reasonable care to avoid misleading clients."

The Center for Fiduciary Studies at the University of Pittsburgh's Katz Graduate School of Business offers two definitions of a 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 advisors and consultants).

Two developments within the last year have highlighted the fiduciary duties of an RIA. The first of these developments is the so-called "Merrill Lynch Rule" (codified as Rule 202(a)(11)-1 under the 1940 Advisers Act), promulgated by the SEC in April 2005. This rule omits from the definition of "investment adviser" certain broker/dealers that provide non-discretionary advice, solely incidental to their brokerage services, regardless of the form of compensation they may receive (e.g., commissions and/or fees).

The Merrill Lynch Rule allows broker/dealers to provide essentially the same services as an RIA without being regulated as RIAs under the 1940 Advisers Act. This wouldn't be such a big deal except for the fact that RIAs must live up to a fiduciary standard while broker/dealers need only comply with the so-called "suitability" standard. These legal investment advising standards governing a fiduciary RIA and a non-fiduciary broker/dealer and its registered representatives are, in fact, very different. Here's how.

Given its fiduciary status, an RIA must follow the "trust" standard—the highest known in law—which requires it to place the interests of its clients ahead of its own and fulfill critical fiduciary duties such as exposing all conflicts of interest which might tempt the RIA to render disinterested investment advice, "utmost good faith," "full and fair disclosure of all material facts" and "reasonable care to avoid misleading clients" as the Supreme Court set forth in its *S.E.C. v. Capital Gains Research Bureau, Inc.* opinion. Under the fiduciary trust standard, an RIA must provide its "best advice" to its clients.

A non-fiduciary broker/dealer and its registered reps follow the "suitability" standard under NASD regulations. This standard doesn't require a registered rep to place the interests of its clients ahead of its own. Under the non-fiduciary suitability standard, a registered rep need provide only "suitable" advice to its clients—even if it knows that the advice is not the best advice. For example, a registered rep that recommends an S&P 500 index mutual fund with a 5% load and high annual expenses when it knows of an equivalent index fund with a similar track record that is no-load and has low annual expenses ordinarily wouldn't be liable to its customer for such a recommendation. It is more likely that an RIA would be liable for engaging in such investment conduct because of its fiduciary status.

Broker/dealers, subject to the Securities Exchange Act of 1934 ("1934 Act"), maintain that they are regulated just as heavily by the SEC, the National Association of Securities Dealers ("NASD") and/or the various agencies in the states in which they do business. Nonetheless, a broker/dealer ordinarily is not deemed a fiduciary—however heavily it otherwise might be regulated by the SEC, the NASD and the states. In fact, none of this less strict regulation with respect to the suitability standard registers broker/dealers and their registered reps with the SEC as RIAs under the more strict regulation concerning the fiduciary standard of the 1940 Advisers Act. (Even when a broker/dealer has dual registration as both a broker/dealer and an RIA, according to the Merrill Lynch Rule the broker/dealer does not necessarily become a fiduciary.) The fundamental difference, then, between the broker/dealer and RIA regulatory schemes is that RIAs are per-se fiduciaries under the 1940 Advisers Act while broker/dealers are not per-se fiduciaries under the 1934 Act.

Even if a non-fiduciary registered rep of a broker/dealer wanted to follow the trust standard of law and become a fiduciary to its clients, it cannot do so legally. This isn't due to any public government regulation but to the private contract a registered rep enters into with its broker/dealer. Such contracts legally *require* a registered rep to place the interests of its broker/dealer before the interests of the registered rep's clients. Under such contracts, a registered rep *does* become a fiduciary – but *only* to its *broker/dealer* - not to its investment clients. In short, a registered rep owes fiduciary duties *directly and only* to its broker/dealer. An RIA, however, owes fiduciary duties *directly and only* to its *investment clients* due to the fact that there's no broker/dealer to get in the way and cause conflicts of interest. From a regulatory and legal vantage, then, the broker/dealer → registered rep relationship is merely one of principal-agency while the RIA → client relationship is one of fiduciary-beneficiary.

Another area highlighting the fiduciary duties of RIAs concerns the nature of the legal recourse their clients have against them. An aggrieved client suing an RIA need only plead a breach of the RIA's statutory fiduciary duty that it owed to the client under the 1940 Advisers Act. The burden of proof then shifts immediately to the RIA to show that it did not breach that duty. An aggrieved client seeking to hold a broker/dealer accountable, however, has the burden of proof to show that the broker/dealer owes a fiduciary duty to its client in the first place. And usually the only way to attempt to surmount that towering hurdle is through arbitration since brokerage customer agreements typically require a customer to forfeit its right to sue in a court of law. In short, the customer of an RIA must only *allege* breach of a duty while that of a broker/dealer must actually *prove* that the broker/dealer owed any fiduciary duties at all.

The second development within the last year that has highlighted the fiduciary duties of an RIA was issuance of a report by the staff of the SEC in May 2005 entitled "Staff Report Concerning Examination of Select Pension Consultants." It's a bit of an understatement to say that this report wasn't kind to the 24 unnamed RIA pension consultants it examined. But that, as they say, is another story for another time…

UPCOMING EVENTS:

Web Seminar: Recent Developments for State Adviser *(NASAA initiatives; state audit findings)*
May 16 2006, 1pm Pacific, **FREE**. Register at https://compliancemax.webex.com/compliancemax/j.php?ED=82975522&RG=1.

Web Seminar: The Fiduciary Standard *(The Fiduciary Standard and the Fiduciary Standard Review)*
June 20, 2006, 1pm Pacific, **FREE**. Register at https://compliancemax.webex.com/compliancemax/j.php?ED=82975537&RG=1.

FPA Far West Round Up
August 12, 2006
Santa Cruz, CA
Corralling Compliance in Your Practice

NAPFA 2006 West Region Conference
September 15, 2006
Portland, OR
Compliance Recipes For A Good Night's Sleep and Compliance Go ' Round—Panel Discussion.

Financial Planning Association of San Diego
September 9, 2006
San Diego, CA
Compliance/Regulatory Environment

KEEP US INFORMED:

To keep you compliant, we rely on you to inform us if you make any material changes that may affect your compliance status. Please contact us if you change your business plan, change products or service lines, hire or terminate agents, change officers and/or directors, change addresses, branch locations and/or record storage facilities, and/or receive new complaints.

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