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Not Just Another "F" Word: Why the Fiduciary Standard Matters

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Sheryl Garrett, CFP
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There is currently a heated debate on Capitol Hill about financial reform and how to address things like dark pools, derivatives, hedge funds, Glass-Steagall, and so on. However, in my book, the most important component of the proposed regulations is the reregulation of financial advice.

The central issue of reregulation involves requiring all those who render financial advice to be held to the fiduciary standard, which requires advisors to put their clients' best interests first; act with prudence; be truthful and forthcoming with all relevant facts; avoid conflicts of interest; and, when conflicts of interest absolutely cannot be avoided, disclose them and manage money in favor of the client.

This is what most investors mistakenly believe *all* advisors are required to do.

Background
Many investors, lawmakers, and *even financial advisors themselves* are confused about the different standards of care currently required of brokers and registered representatives and registered investment advisors.

In a 2008 study reported by the RAND Institute, 63% of investors stated that they believe registered representatives/brokers are required to act in the best interests of their clients. (They aren't, in most cases.) Seventy percent believed that registered representatives and brokers must disclose any conflicts of interest. (They don't, in general.) You can see, then, the need to reregulate financial advice -- and to hold all financial advisors to the fiduciary standard.

Bloomberg recently reported that Sen. Tim Johnson is striving to get a fiduciary standard for brokers *dropped* from the Senate banking committee's financial-regulation overhaul. Instead, Johnson proposed an 18-month study by the SEC to determine whether the standard is needed.

To which I say: Come on!
These regulations are 70-plus years old, and these issues have been thoroughly vetted by consumer watchdog groups, Congress, and the financial services industry on numerous occasions over the years. The time is *now* for meaningful financial reform that protects the investor and holds the advisor accountable for their advice.

To illuminate the importance of the fiduciary standard, I want to share a legal complaint I witnessed firsthand. The story summarizes what the advisor, investors, and witnesses expressed in depositions preceding a jury trial, as well as actual testimony which took place during the trial. The names have been changed to protect identities.

A real-life example
Sarah and Sam Simmons, middle-income married homeowners with three children, were good savers. Sarah worked for a large company for 30 years and had accumulated a sizable nest egg, primarily employer stock in her 401(k).

Sarah felt comfortable with the company and the stock -- it had been good to her. She also had a defined-benefit pension plan. Sarah liked her job and had no imminent retirement plans. Yet the Simmonses were saving aggressively enough so that they would never have to worry about money in retirement. Her husband Sam also had a pension. They were living the American dream.

Then, at age 47, Sarah suffered a brain injury. She was permanently disabled and could not return to work. After three months in a coma and a total of 12 months of company-paid disability, she was forced to "retire" at age 48. According to the Simmons' testimony, Sarah was incapable of taking care of herself, let alone managing her personal finances, or even participating in a meaningful conversation about important decisions at that time in her life.

Fortunately, the Simmonses lived a modest, middle-income lifestyle and had already accumulated substantial

retirement assets ($545,000 in addition to Sam's pension). Remember, Sarah would *never* be able to work again. That money would have to last for the rest of her lifetime. The Simmonses testified that they didn't know anything about investing, but they were good savers.

Seeking help
They sought out financial advice from Ms. Johnson, who was to their knowledge an expert on Sarah's company's retirement plan. The Simmons liked her and trusted her -- and had no reason to believe that Ms. Johnson would do anything not in their best interest.

The Simmons testified that Ms. Johnson assured them that she'd take care of everything. That was part of her service. They claimed that they didn't know what to do about their financial situation, so they turned to Ms. Johnson and did exactly what she told them to do with Sarah's money so that she would be taken care of for the rest of her life.

However, according to Ms. Johnson, she did not render any advice to the Simmons. She testified that Sam and Sarah had already decided to take a lump-sum distribution from their guaranteed defined-benefit pension plan, drop their retiree life insurance, and invest in a balanced portfolio of mutual funds and variable annuity subaccounts. As what's known as a registered principal, Ms. Johnson merely represented the features and benefits of the products she was licensed to sell. Ms. Johnson testified that she was required to make recommendations that were "suitable" for the Simmons. Johnson received commission income in excess of $30,000 for these services.

Best interests?
In trying to better understand the definition of "suitable" or "suitability," the word "reasonable" comes up. Under the fiduciary standard, an advisor is required by law to provide recommendations in the "best" interests of the investor. There's a big difference between "reasonable" and "best."

Ms. Johnson was also required to provide full and complete disclosure about all the choices she advised them on or assisted them in making. That did not happen, according to the Simmons.

Specifically, there was no discussion of the benefits of the defined-benefit pension plan. Ms. Johnson testified that she didn't discuss the benefits of having a guaranteed monthly pension paycheck for life, because the Simmons had already decided they wanted the lump-sum distribution.

However, she did prepare paperwork to effectuate the lump-sum distribution into an IRA account. If the pension was left intact, Ms. Johnson would not be able to sell investments to the client or manage these funds and generate compensation from liquidating the pension plan.

There's more
The Simmons did not recall any meaningful discussion of the risks and costs involved in managing their investment portfolio after cashing out the pension plan.

From day one, the Simmons withdrew more from these retirement accounts than was sustainable -- there was no way the accounts would last through their lifetime. Ms. Johnson effectuated the distributions, yet neither the advisor nor her brokerage firm has any proof or documentation that indicates that Ms. Johnson was not in support of the withdrawal rate.

The Simmons allege that Ms. Johnson told them how much they could withdraw from their accounts and effectuated the distributions on their behalf, stating that they would be set for life.

Disclosures
Ms. Johnson was required to provide full and fair disclosure of all material information related to the investments she sold. The Simmons allege, and the testimony supports, that this did not occur.

For example, Ms. Johnson transferred the pension plan proceeds and invested it into rear-load mutual funds, class B-shares, which incur a substantial surrender penalty and higher overall fees. Let's compare the two choices:

Fee	Class A	Class B
Load	2.5% front*	5% back load for first 5 years, declining each year
12(b)-1 fees	0.18% to 0.25%	1%

Total annual expenses	0.88% to 1.13%	1.69% to 1.94%

*The Simmons had enough money invested to reach a break-point, lowering the A-share load fee.

The investment in class B-shares was substantially more expensive than the alternative A-share class, while still using the same mutual fund vehicles (presuming they were appropriate for the Simmons). Not only did the class-B shares yield higher fees to the fund company, they brought in higher commissions for the advisor. (Is *that* in the best interest of the client?)

Under testimony Ms. Johnson said the Simmons paid no commission when purchasing B-shares, which is partially correct. The Simmons paid no *up-front* commissions. However, they paid a very significant commission when they took their monthly distribution checks, and substantially more on an annual basis than with the alternative A-share classes.

More pain, less gains
Ms. Johnson then helped the Simmons purchase a variable annuity with the 401(k) rollover money. The advisor stated that Mr. Simmons specifically asked her for this investment product.

A variable annuity has three useful purposes, which help offset the additional expense and limited flexible inherent with the annuity, none of which applied to the 401(k) rollover. According to FINRA, as well as Ms. Johnson's own brokerage company's procedure manual, there are three primary reasons to own a variable annuity:

1. Tax deferral -- but this money was already tax-deferred.
2. Death benefits -- which were negated due to the withdrawal rate and more expensive than the life insurance that was dropped.
3. Lifetime income -- the defined-benefit pension plan would have been my preferred approach to ensuring lifetime income.

When the class B-shares automatically converted to A-shares at the end of the surrender penalty period and the annual expense went down considerably, these mutual fund accounts were liquidated and the proceeds used to purchase another variable annuity.

There was absolutely no benefit in this exchange to Ms. Simmons. However, it was extremely lucrative for the advisor who made the sale. The advisor also hired a marketing timing service to manage the subaccounts within the variable annuity. This added another 1.5% in expenses per year. The advisor received one half of this fee for the life of the account for making the referral.

The moral
Whether you believe the Simmons' allegations, one fact is clear: Ms. Johnson was a "fiduciary" to Sarah. This is not just my opinion. The jury declared that Ms. Johnson owed a fiduciary duty to Sarah Simmons.

Unfortunately, the advisors involved, their broker-dealer, and the jury failed to understand that they were *required* to fulfill their fiduciary duties to the Simmons as established under the Investment Advisors Act of 1940 and affirmed by the Supreme Court. The buck is supposed to stop with the fiduciary, not the client. But Sarah and Sam Simmons lost their case in trial, and to make matters worse, the brokerage firm placed a lien on their home to recoup court costs/expenses.

There are five core principles of the Advisors Act that establish fiduciary requirements:

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

What do you think? Do you believe investors have the right to rely on the guidance and recommendations of their financial advisor? Can they hold somebody else responsible for their poor decisions?

As the founder of Garrett Planning Network, a group of fee-only (no commissions) fiduciary financial planners, this story breaks my heart. Because even if it's *caveat emptor*, the sad reality is that 11 years have passed -- and the Simmonses, now nearly 60, are virtually broke.

Thus the need for the fiduciary regulatory standard. And thus the need for savers and investors to get serious

about finding a financial advisor who is required by law to put their best interests first!

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Sheryl Garrett is the founder of Garrett Planning Network, a fee-only network of financial advisors. The Motley Fool has a disclosure policy.

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