



The Unintended Consequences of a Regulated Environment?

*Investment Advisors Face Challenges Dealing with Clients
during Financial Uncertainty*

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Financial advisors beware... new legislation and regulations have been enacted, and you will face new hurdles conducting your daily operations. But, in this case, new does not necessarily mean improved. During times like these, regulators feel the need to do something, even if that something turns out to be wrong down the road.

Likewise, trial lawyers are circling their wagons, seeking out wronged investors with claims that "unscrupulous" financial advisors failed to meet their fiduciary obligations. As the credit crisis morphed into the full-fledged collapse of the global financial system, nervous investors watched their portfolios dramatically decline in value. Now they are looking for answers, if not more, and the promises of those lawyers sound too good to pass up.

Now that the election season has ended, legislators and regulators alike will focus on fixing the financial crisis and not just talking about it. They may begin proposing new rules and regulations to improve the seemingly broken system. Financial advisors need to monitor these proposals closely, as their very livelihoods will be impacted.

Here are a few regulatory areas that will be addressed in the days, weeks, months, and years to come.

Expanded Powers for FINRA

FINRA (the Financial Industry Regulatory Authority) has been looking to expand its regulatory reach beyond broker-dealer compliance to become the primary regulator over mutual funds, insurance, investment advisors, and even mortgage brokers. Some investment advisors tend to ignore FINRA, believing they are immune to its oversight and only brokers must answer to them. Others remain fearful of all regulators; lawyers and consultants often use the mere FINRA name to scare members into paying for unnecessary services. Should FINRA's role



expand, such scare tactics will become realities and advisors will be forced to answer to another regulator. Additionally, as FINRA gains even more authority, many independents worry that they will lose their voice in the industry, as the larger firms exercise greater control, particularly over such issues as rulemaking.

Principle- vs. Rules-Based Regulations

Since its creation in 2007, FINRA has incorporated more broadly interpreted principle-based regulations while consolidating the NASD and NYSE rulebooks. Moving forward, expect the regulators to apply certain "must do" rules-based regulations regarding compliance issues. Smaller independents remain concerned that the rules-based approach does not adequately consider them; very little is left to interpretation as decisions are consistent and uniform regardless of the size of the underlying firm or business model used.

Greater Oversight over 529 Plans

Currently these education savings accounts are regulated by the MSRB (Municipal Securities Rulemaking Board), and not the SEC (Securities and Exchange Commission), so investment advisors have believed they are immune to direct oversight. Expect Congress to take a more active role in protecting these education accounts by giving FINRA a greater regulatory role as the SRO consolidates its power. As a result, some advisors may be less likely to recommend 529s.

Hedge Funds

This industry is sure to face increased oversight, and regulators are likely to target leverage and reporting transparency first. With other regulations likely to touch on custody, ethics (insider trading) and controls, hedge funds may soon be facing what the SEC likes to call a "culture of compliance." In other words, this "gotcha" regulatory mentality generally implies "we will get you for everything."



A Little Refresher Course

With regard to potential litigation, advisors would be wise to examine how they approach adhering to their fiduciary obligations. The definition of what constitutes a fiduciary responsibility is often gray, at best, though advisors always should act in the best interests of their clients when it comes to investment supervision, account management, and security suitability. While these issues may seem more important because of the volatile market conditions, the onus on the advisor is no greater today than in less stressful times. While no one can adequately predict what new regulations may be in store, now is an opportune time to reevaluate efforts regarding suitability, client communications, and file documentation.

Suitability

The old Rip Van Winkle approach to investing is no longer acceptable. Unfortunately, some advisors seem to “fall asleep on the job” and interact with their clients quite infrequently. Once upon a time, advisors preached “buy and hold” - an admirable strategy for long-term investing, but one that often turned into “buy and forget” once those initial dollars were invested. Some advisors filled out their firm’s required “objectives” and “experience” checklists, classified the account in a long-term time horizon category, and moved on to the next investor. Bear in mind, once an account is open, the initial suitability is not cast in stone and periodic reviews are required to meet an advisor’s fiduciary responsibilities.

So what should the advisor be doing in today’s markets to satisfy suitability standards? If they simply maintain the long-term approach of “buy and hold,” they may be criticized for not doing enough to protect clients who grow ever more concerned when their custodial statements arrive each month. On the other hand, if they actively rebalance their clients’ portfolios, to lock in some losses (that then cannot be recouped), and move into more “suitable” securities, they can still be accused of churning or failure to supervise. In reality, there is no one correct solution. Every client relationship is unique; every client account is different and should be managed according to current objectives and tolerance for risk. Evaluate each relationship carefully, starting with effective and ongoing client communications.



Client Communications

The need for communication, education, and “good old-fashioned” handholding has never been more important than it is today. Investors come to their advisors demanding answers, but often they really just need a calming voice to ease their concerns. But it should not take a crisis to prompt such discussions and correspondences from advisors. In fact, according to their fiduciary obligations, advisors are required to stay in contact with their clients to learn about lifestyle and objective changes and solicit their views on the investment approach that has been enacted.

Even when advisors maintain discretionary authority over clients’ accounts, they should conduct regular reviews as defined in their ADVs to keep clients abreast of developments in the markets, the economy, and their portfolios. Advisors need to make sure their clients understand the approach being taken and are in agreement with the overall management of the portfolios. Advisors should never make trading decisions that could be construed as arbitrary without client input or, at the very least, a rationale based on prior communications and signed documentation.

Document Everything

The days of generating business based on charm, good looks, and a great personality are long gone, and smooth talking “professionals” cannot simply talk themselves out of jams anymore. That used-car salesman approach gave investment advisors a bad name and prompted stronger oversight over the entire industry (that may now get even stronger once the regulators get through). Complete and comprehensive documentation will remain key, both for the future and on a look-back basis. Advisors must be prepared for the ever-changing regulatory environment, and the best way to be prepared is to document everything. The only way to defend a prior action that becomes questionable in nature is to provide justification through prior client communication and signed and dated notes to the files.

Within the Form ADV filed with the SEC, advisors share personal and professional backgrounds, issues about compensation, and business strategies that include client review policies. Advisors must be prepared to follow what they promise within the ADV, provide documented proof that such reviews occurred on a timely basis, and show how clients responded to such meetings and communications. Should they choose to keep notes of these interactions electronically, they should print them out and file them in case they can’t access them when needed down the road. Oral recollection of past conversations and communications will be considered hearsay when it cannot be corroborated with a signed and dated hard copy.



In the aftermath of the current financial challenge, the regulatory environment for advisors will undergo some enhancements, and trial lawyers may come seeking reparation for losses in their clients' portfolios. But, in reality, the role of the advisor will not be changing. Advisors can avoid any and all pitfalls by adhering to strict investor suitability standards, engaging in effective client communications, and documenting everything.

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