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Attorney-Profession Privilege

Synopsis: ***Tom Giachetti warns the RIA world that the SEC's remote audits are nothing to take lightly.***

Takeaways: ***Pay a LOT of attention to client share classes and any billing inconsistencies. Recognize that nondiscretionary assets don't count as your published AUM. Make sure your ADV, policies & procedures manual and your client agreements are consistent with each other.***

Before I attended Stark & Stark attorney Tom Giachetti's webinar presentation (part of the Insider's Forum conference), I had the vague idea that the SEC had paused its examination schedule, and that advisors would not be getting that dreaded tap on the shoulder until the pandemic was over and auditors were once again permitted to camp out in your conference room.

Wrong! Based on an informal survey I conducted after Giachetti's presentation, it seems clear that the SEC has actually stepped up its examination frequency from visiting fewer than 10% of federally-regulated RIAs a year to conducting more efficient remote audits of more than 15%. Interestingly, it appears that the Commission had actually started doing these remote audits before the pandemic.

And, as you'll see in the following article, the examiner teams may be using some new AI-like analytical tools which pull out insights and inconsistencies

EARLY WARNING

The 2021 conference season is bound to be chaotic, especially in the first six months, as NAPFA, NorCal, AICPA, T3, Morningstar, FPA NexGen, Fi360 and others try to navigate whether to hold their meetings in-person, remotely or some combination of both. Will they be rescheduled?

I'm planning to offer some clarity about the conference scene in 2021, with recommended conferences, times, dates and what the current plan is. We can revise this document as the planning becomes clearer—and we'd appreciate your help. Which meetings do you plan to attend, remotely or in-person, and which would you recommend for other advisors? You can send your thoughts to *bob@bobveres.com*.

The annual T3/Inside Information software survey is still open, so you can still rate your programs and solutions in 32 software/solution categories. Taking the survey is an education in the diversity of programs that are available—and you also vote for the most important tech solution category in your business life. Please, if you can, spend 11 minutes (average time to complete the survey) and give us your feedback on your own tech suite. And, of course, we'll distribute the full report to the advisor community.

from the reams of data the SEC requires you to send (in a specified format)—allowing more leverage of current staff. The examiners are suddenly able to come up with some scarily specific nitpicky questions about consistency of fee billing, consistency between your various disclosures and agreements, and your share class selections.

Giachetti (*https://www.stark-stark.com/attorneys/thomas-giachetti/*) is certainly in a position to notice these trends, as the profession's leading securities attorney who specializes in SEC and state compliance issues. "I don't want anyone to think that just because we're in a pandemic, we don't have to worry about an SEC examination," he told the audience at the start of the webinar. "That is certainly not the case."

Giachetti added that the remote examination process goes on much longer now than the on-site versions; some of the socially-distanced audits have run from six to nine months from the first notice to produce records to the final remote exit interview.

What should you be prepared for? The SEC examiners, Giachetti told the group, believe that they're more astute consumers than your clients. So, on behalf of your clients, the audit teams are looking for ways to force advisory firms to reimburse clients based on unfair billing practices, sloppy investment selection or charging more in fees to one client than others—all things that the client might have missed.

The presentation started with billing issues. Giachetti said that the SEC is actively looking for even minor discrepancies between advisory firm ADVs and client agreements, and discrepancies between both of those and how clients are actually paying their advisors. The breakpoint levels might be different from one disclosure to another, the percentage amount for each level might not match, and, of course, some clients might be paying lower fees than others, which doesn't show up on your ADV.

Whenever it finds a discrepancy between your ADV fee disclosures and what you actually charge clients, the SEC will calculate the lowest possible interpretation, and require that you rebate clients the difference.

That means advisory firms can't be sloppy or imprecise in their fee disclosures. "For instance, if the ADV says that on the first million you charge 1%, and on the next million you charge 80 basis points, and on the next million you charge 75 basis points," said Giachetti, "then if the client agreement says 1% for $1 million, 80 basis points for $2 million, 75 basis points for $3 million, you've got a problem."

Whenever it finds a discrepancy, the SEC will calculate the lowest possible interpretation of these mismatching schedules, and then insist that the clients who paid more than this interpretation be reimbursed for the difference, going back at least two years. "These discrepancies will be construed against the advisor every time," Giachetti told the audience.

Another problem arises in situations where advisory firms are billing clients in advance rather than in arrears. The SEC is looking at whether, when clients leave the firm, they are automatically rebated proportionately for the part of the month where they are no longer clients. As you'll see in the next article, the current SEC audit asks for the names and account information of former clients, and carefully checks to see whether they were billed correctly.

The examiners are also checking how the firm handles its advance billing during a quarter where a client adds (let's say) $1 million to the portfolio. The firm might start billing on that amount right away. "But what if the client took away $1 million?" Giachetti asks. "Do you reduce your fees accordingly? If not, you've got a problem, and the SEC is going to be looking at that. You cannot win with money coming in and the client lose when money goes out. If you make intra-quarter fee adjustments, there should be a policy, and you should indicate that there is a threshold."

Giachetti recommended that each firm have, in the policies and procedures manual and in its office activities, a process where it routinely samples client fee debits to make sure clients were correctly billed from their custodial accounts.

Other discrepancies can arise out of what would appear to be simple shifts in policy. "If you

were to change your fee schedule and lower your AUM fees," said Giachetti, "did you continue to have existing clients pay higher fees? If so, then you're in jeopardy of the SEC saying: *you need to rebate all of your existing clients to that lower fee schedule*. Why?" he asked rhetorically. "Because lowering your fees is a material change, and it's material for clients to know that if they were to start with you tomorrow, they would have the benefit of a lower fee schedule. You have an obligation to advise them of that."

You can expect the SEC to take an extra look at any flat fee arrangements for some clients (younger or less wealthy ones), while others are being charged (higher) AUM fees. "If you have some clients who pay a flat fee, where you're charging a different fee structure for smaller clients," said Giachetti, "I would want there to be some kind of policy that shows that the AUM clients are getting more services than the smaller clients who have a limited number of assets."

If you charge more for some clients than others, the SEC may ask why and request your work product for the two groups. "If you have negotiated fees, there should be a reason for it," said Giachetti. "If the SEC asks why this client paid less than others, you need to be able to say: *here's the reason why*." (Interestingly, as we'll see in the next article, the SEC may not be prepared to evaluate your work product for different clients if the services are financial planning-related.)

Giachetti said that 'non-level' fees—such as charging a lower AUM percentage for fixed income assets and a higher one for the equity part of client portfolios, or charging not at all for cash under your AUM arrangement—tends to vex the SEC examiners and lead to additional questioning. "That creates a conflict of interest to allocate more assets to the higher-paying asset class," he told the group. "So you need to very clearly disclose that conflict to your clients. The SEC is going to be looking for that disclosure."

His recommendation: charge the same on all assets, including cash. Isn't cash an asset class like everything else in the portfolio?

Some advisors charge all-in AUM fees that cover the transaction costs. Giachetti told the audience that he sees less of this today, now that the larger custodians have waived trading fees on equities and ETFs. But they still charge transaction fees on mutual funds, and some advisors still prefer to cover those expenses out of their own pocket.

The SEC will take an interest in non-level fees where you charge more for the equity portion of client portfolios than bonds, or don't charge for cash.

This kind of "wrap" fee structure tends to trigger extra scrutiny from the SEC because it raises 'reverse churning' conflict of interest issues. If you aren't making trades in client accounts on a regular basis, is that because you don't want to pay those extra trading fees?

The biggest problems arise whenever a firm covers those transaction costs on an all-in arrangement and then uses an NTF share class in client portfolios. "If I'm buying no-transaction fee mutual funds in a wrap program, I may have a lot of explaining to do," Giachetti said. "If you can't justify not buying the institutional share class because you don't have a lot of portfolio activity, then you're going to be writing a check back to your clients."

"If you have an asset-based pricing arrangement [that covers the transactions]," said Giachetti, "then

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it is absolutely incumbent on the advisor to test it annually to make sure that clients are better off on your model vs. where they would be paying for each transaction. One year may not be enough to determine whether or not there should be a switch," he added, "but you need to at least take a look every year, to show the SEC that you are continuing to review to make sure that the client is better off having you pay the transaction fees."

The reverse churning issue may come up anyway for advisors (which is most of you) who follow a buy-and-hold investment philosophy. "If you charge by AUM, the SEC is going to ask: are you really monitoring the portfolio?" Giachetti said. "I developed a paragraph for the ADV about three years ago to make it clear that just because you don't turn the portfolio over, it doesn't mean you're not doing your job. If you bought a good fund, and the fund is still consistent with client objectives, there's no reason to turn it over."

Of course, much of the AUM fee, for many advisors, actually pays for financial planning services. But Giachetti cited instances where the SEC will look at how much more wealthier clients are paying than less-wealthy ones, and inquire whether the people paying higher fees are getting more work. "I have seen SEC examiners ask: *how much financial planning did Mr. and Ms. Smith receive last year?*" he said. *"It looks like they didn't get very much. Did you give them a refund?"*

Advisors may be asked to provide a full CRM dump of all the things they did for some clients, plus their work products. Once again, however, chances are the examiners won't be able to discern whether clients were fairly served or not. So when asked to show your work, err on the side of producing a lot of material.

You may be making implied guarantees if you say on your website that your firm 'provides' 'comprehensive planning services and meets with clients four times a year.

Puffery

At this point, the presentation turned to what Giachetti referred to as 'puffery'—aka marketing language on your website which makes clients more likely to hire you over the firm down the street. Does your website say that you '*provide*' '*comprehensive*' financial planning to your clients? If so, be careful that the examiners won't find some clients who never asked for financial planning, or others who received less-than-comprehensive planning because some areas didn't need to be covered.

Giachetti warned against making explicit promises of '*comprehensive*' service on your website unless you're making sure those services are provided in every client engagement. If not, remove the language from your website. His preferred ADV language, he said, includes something like *'it is incumbent on the client to advise us about financial planning issues, and whether they want to sit down with us and address financial planning matters. We believe financial planning is important and there should be an ongoing review. However, if the client does not take advantage of this offer, then there is no change in our fee schedule.'*

Similarly, if your website says that you *'treat your clients like family,'* or '*provide*' quarterly client review meetings, those statements might be viewed by the SEC as firm promises to all clients. Are those promises kept in all cases? If not, that language should be deleted from your website before the SEC knocks on your door.

"Rather than saying that you meet with your clients quarterly or yearly, say that you remain available for meeting quarterly, so you are not contractually obligating yourself," Giachetti told the audience. "Rather than saying you provide comprehensive estate planning, say that you remain available to assist with the estate planning process with other professionals, and to review insurance-related issues. If you say you DO those things," Giachetti added, "and somebody dies without insurance or needs insurance but they've became uninsurable during your relationship, you may find yourself defending your promise in court."

The same with saying that you provide '*state-of-the-art*' planning services, or put awards on your website which say that you're one of the '*top 50 planning firms*' in your area. (The author of this article gets

routinely solicited to be included on those lists.)

"One of the most aggressive areas for the SEC in this cycle are rankings and recognitions," Giachetti told the audience. "If you must include rankings or third-party awards, there must be conspicuous disclosure as to what the ranking criteria is, either through a conspicuous link or a direct disclosure."

The SEC has also gotten picky about how you disclose your assets under management. Giachetti said that many firms are adding 'assets under advisement,' to their AUM—which the SEC will view as an attempt to make your firm seem bigger than it is. "There is no such thing as 'assets under advisement,'" he told the audience. "That is not a regulatory term."

But what if you're giving advice on a client's 401(k) assets, and including those holdings in your household allocation mix? They still count under your firm's AUM total. Don't they?

"The SEC, in its guidance, says that nondiscretionary assets do not count as assets under management unless you can pass a three-prong test," said Giachetti.

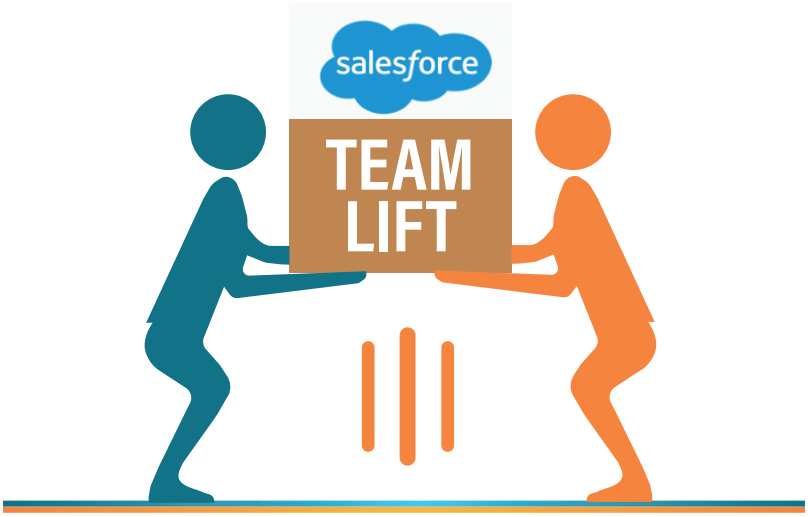
Most advisors can probably pass the first one on client 401(k) assets: *you are responsible for making the recommendation of what investments the client should be selecting*. They might be able to pass the second one: that *you monitor those assets on an ongoing and continuous basis*.

But can they pass the third?—that *the advisor (not the client) is responsible for making the actual transactions*.

"Who is making the actual transactions in that 401(k) plan?" Giachetti asked the audience. Then he helpfully answered: "The transactions are being made by the participant." The advisory firm just failed prong three of the test, and including those 'assets under advisement' will get the firm written up in the examination's final exit letter.

Giachetti added that separate account manager assets that clients own, or assets managed by 3rd party managers, also don't count under your AUM total unless you (the advisor) have the power to hire and fire the manager. "If the client has the authority, where they sign the agreement and sign the termination," Giachetti said, "then those are not assets under

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Finally, Giachetti talked about minimum assets or minimum fees. "I look at Part I of the ADV, and I see that the firm has a minimum investment size of $750,000," he said. "Then I look at their accounts, and there are accommodation accounts of $94,000, $105,000 and so on. You have to tell the truth on the ADV," he continued. "If you say that your minimum asset level is $750,000, but in actual practice you will take smaller accounts, the SEC will say that you're making yourself look bigger or more established than you actually are." More puffery.

His advice: if you accept accommodation accounts, take that minimum account disclosure off of your ADV. Alternatively, you could engage in fairly complicated language detailing when and how you would accept what Giachetti calls 'courtesy accounts.' (Relatives of an existing client? Friends of a good referral source?)

Policies and procedures

The SEC's remote examiners are still focused on bread-and-butter issues that are familiar from past exams. They want to see that you have policies and procedures regarding certain routine activities in the office, and that your policies and procedures manual matches up with activities that are actually performed in the office on a daily or weekly basis.

In this regard, Giachetti said that every RIA firm should have written protocols that describe what the firm does when you get a new client, how you onboard new employees, and how you vet a new vendor who might be handling client information. How often does your compliance committee meet, or, alternatively, does your CCO meet regularly with senior management to talk about issues that may have come up? If so, where are the meeting notes? What problems did the CCO uncover and how were they addressed?

It's hard to argue that you rigorously follow the documented policies when there are discrepancies among the various documents.

Of course, it's hard to argue that you rigorously follow the documented policies when there are discrepancies among the various documents. "When I come into a firm to do a mock audit," said Giachetti, "I often find conflicting language, where the ADV says something different from the client agreements vs. the policies and procedures manual vs. the marketing language on their website. If you've purchased your policies and procedures manual from a different party than you did your ADV," he added, "then I promise you they are not going to match."

You might also have trouble arguing that you follow policies that were written some years ago. "You can't tell the SEC that you have a strong compliance culture when your policies are dated 2017," said Giachetti.

One key component of the SEC's policies examination is your cybersecurity activities. Giachetti talked about the importance of getting signed confidentiality agreements from the firms that provide cleaning staff and security guards who would have access to your offices after hours. In addition, he said that the CCO should periodically come into the office for an inspection an hour or so before everyone else arrives, and walk around and make sure the desks are clean.

"We have to be really careful about tax returns or any document that might have the client's name, Social Security number and other personal information," Giachetti told the group. "Today, everybody [including the security guards and cleaning staff] carries a phone, and that phone generally has a camera," he added.

The SEC also looks at your vendor due diligence. "You cannot say that just because some company is on your custodian's platform, you can assume they're good," Giachetti said. "You need to do some real due diligence. We give our clients a third-party due diligence checklist." If you use asset managers on the platform, he recommends that advisory firms ask what the custodian is doing to vet those managers on an ongoing basis.

In addition, Giachetti recommended that every advisor

listening to his presentation make sure they have a cyber insurance policy, which will help them, if they suffer a breach, understand the notification requirements in each state that clients reside, and potentially pay for the cost of making those notifications.

Another policy the SEC will be looking for is how you make sure that your clients—particularly elderly clients—are protected from financial exploitation. "The SEC's exam now has a bunch of questions on those issues," said Giachetti. "Put it on your protocol for the first client meeting," he advised. "And then every year, when you deliver the ADV, ask your clients if they want to establish a trusted contact, or modify their trusted contact."

Even if the clients don't want to provide the name of somebody you should contact if you suspect abuse or declining mental capacity, you should document that you raised the issue every year.

Supervision and mock audits

Giachetti noted in the presentation that many advisory firms now have multiple offices. When they audit those firms, SEC examiners are looking for evidence that the branches are being supervised the same as if everybody were in the home office. This is especially true now that so many staff members are working remotely; they are, in effect, branch locations of the firm. "Those firms are having longer exams," Giachetti told the group, "because they need to demonstrate that the CCO is adequately supervising all those individuals."

Giachetti also warned that advisors need to be careful about mock audits. "There is only one way to do a mock exam," he told the group. "You know exactly what is going to be on it, and those are things that the SEC is going to be looking at."

If you're having non-lawyers conduct those audits, and especially if they provide a written report, you might be at a disadvantage when the SEC knocks on your door. "I get calls every week," Giachetti continued, "from firms saying, *Tom, I need your help. Our consultant gave us a 35-page response after coming in to see us, and most of the stuff is wrong or we didn't do the things they said we did*."

The biggest problem with that document is that the SEC is entirely within its rights to request it, review it, and hold the advisory firm accountable for what it says. "That is not a mock exam," said Giachetti about the consultant report. "That is putting a noose around your neck." When he or his team conducts a mock exam, Giachetti doesn't produce a written report; issues are discussed verbally, and those conversations are protected by the attorney-client privilege.

In general, Giachetti said that the SEC is primarily interested in talking with the RIA firm's chief compliance officer, and that person should be the point-person for all document requests and follow-up discussions.

In the past, you would see SEC examiners at least attempt to communicate with other staff members, but Giachetti said that he isn't seeing as much of that in these remote exams. But they might insist on a broader audience if the CCO is having trouble answering basic questions.

Every CCO should be on the firm's investment committee, to watch and listen. Why would you think that your CCO doesn't have to understand about investments?

"I am dealing with an exam right now where the CCO was never permitted to sit in on the investment committee meetings," said Giachetti. "Every CCO should be on the investment committee, to listen and learn. You are an investment management firm. Why do you think that the CCO doesn't have to understand anything about investments?"

If the CCO pleads ignorance about basic investment policies, expect the examiners to request some conversations with the chair of the investment committee with respect to client investment accounts—which, of course, is the bulk of the actual exam. Suddenly, you have multiple points of contact and the potential to tell conflicting stories about how things are handled.

Giachetti said that instead of "offering" your Form ADV once a year, you should put it on

your website and provide clients with a link, so they can view it at their leisure. When you make amendments, send a link to the updated form. While you're at it, he said, tell clients that you are managing their assets to the current investment objectives, but they should please let you know if they want to add or impose any restrictions. And please let you know if they want to implement a trusted contact or change the one on file.

The sheer magnitude of issues that the SEC is routinely raising in its examination process would be scary, until you realize that most of what Giachetti is talking about should be routine things to handle or manage on an ongoing basis. A well-run office should have detailed policies and procedures. A clear description of your firm's activities and client services on your Form ADV helps get client relations off to a productive start. Checking to make sure that clients are in the thriftiest share classes should be a routine part of the service.

I thought this presentation was a great way for advisory firms to check out their own readiness for an SEC audit—and also to recognize that these audits are going to become more frequent than they ever were before. But what are the actual experiences like? The next article lets you look at a variety of SEC audits through the eyes of advisors who have undergone the remote audit experience. One takeaway, as you'll see shortly, is that there can be significant differences from one to another. ■

Exam Experiences

Synopsis: ***What are SEC examiners focusing on in their new remote inspection regime?***

Takeaways: ***Beware of inexperienced and hostile examiners who are trying to impress their boss. If the auditors ask an unclear question, patiently get clarification. Lean on your portfolio reporting software provider or custodian for help with the document requests.***

After watching the Tom Giachetti presentation (*see previous article*), I sent out a message to my readership, asking if any of my *Inside Information* readers have been through one of these remote audits. The response surprised me; I got back about ten times the number of responses that I had been expecting. In the interview process, I asked what they most dreaded about the document request, where the SEC examiners seemed to be focusing their attention, and in general the tone of the examination. How knowledgeable are the auditors, and how did they communicate through their remote audit process?

> ***It appears that the SEC has actually increased the number of audits during the pandemic.***

Pretty much everybody I talked with who experienced a pandemic audit said that they were amazed that the SEC would tap their shoulders at such an awkward time. "The primary examiner called me on March 9 and announced who she was and why she was calling," says Scott Beaudin, of Pathway Financial Advisors in South Burlington, VT and Atlanta, GA. "I literally started laughing. And she said: *that's not the reaction that I normally get*."

Brian Fenn, with Carolina Capital Consulting in Charlotte, NC, was contacted on April 23 with the records request. "What's funny about that," he says, "is that our last exam was also at a bad time: the fall of 2008. To get both audits in the midst of the decimation of the economy and all that, we felt kind of snake bit."

Eve Kaplan, of Kaplan Financial Advisors in Berkeley Heights, NJ had the phone ring on March 7, when, she says, "things were starting to hit the fan."

The caller ID said that the call was coming from the SEC. "I thought, *oh, really? Seriously?*" says Kaplan. "I wondered if they had gone out of their way to schedule it during the pandemic."

I made an exception when I interviewed Elyse Foster, whose audit actually started before the pandemic—she got her tap on the shoulder two weeks before the

Christmas holidays. "Then, when I corresponded with the audit supervisor," says Foster, "she said, *oh, I'll be off for the next two weeks for the holidays*." Foster's initial interview was in person, but as the COVID disease began to spread, it became a remote process.

Chris Brown, of Ivy League Financial Advisors in Rockville, MD received a call not only in the middle of the pandemic, in the middle of July, but a day after he had moved from one house to another.

What kind of experience did they have? It appears that every remote audit includes three individuals on the line. There's a supervisory person who mostly listens but occasionally interjects. There's a lead examiner who may or may not be in training, but who is sometimes (how to put this delicately?) not extremely knowledgeable about the business model of fiduciary RIA firms. And the team will include an accountant who is in charge of running the numbers.

The level of knowledge and the tone varied widely from team to team, and usually depended on the experience level of the least senior person. Salmen reports that the lead person on his team seemed to be nervous and often deferred to the supervisory auditor. Beaudin and Fenn felt like their lead examiners were very professional.

Nobody reported that they felt that the SEC examiners truly understood a financial planning business.

For example? Kurt Box, of The Advocates in Houston, TX, was initially perplexed by persistent questions about his firm's proprietary trading activities and how his CCO prevented the advisors from front-running. "It was like they thought we were a Wall Street firm, with a prop desk or something," he says, shaking his head. "I don't think they had a good grasp about how a real RIA operates—that the firm is more about financial planning than trading."

Foster actually set the tone in her audit by forcing the examiners to sit through a Powerpoint presentation that showed them how long the firm had been in business, the type of clients they work with, the planning work they do and how they charge fees, the fact that they are fee-only, and other details like their retention levels and client to staff ratio.

"They didn't want that, and they pushed back," says Foster. "But I said, *bear with me. I want you to understand our firm, because not all firms are the same. It won't take long, but I want to start off by sharing who we are*."

The auditors really had no choice but to submit to the presentation, and surprised Foster at the end. "One of them said, *you know what? That really was helpful,*" she says. "*It tells us a story*."

Roy Ballentine, of Ballentine Partners (offices in Wolfeboro, NH and Boston, MA) says that his firm's audit—out of the SEC's Boston office—was very aggressive. "The initial interviews were pretty hostile," he says. "The most aggressive guy was the youngest member of the team, and I wondered if he was trying to impress his bosses."

Every remote audit includes three individuals: the lead person who may or may not be experienced, a supervisor and an account who runs the numbers.

Ballentine found that many of the questions and requests posed by the lead auditor were not clear—and of course this is a tactic that attorneys will use in cross-examination; ask a question that is kind of fuzzy, and then if you get what appears to be a confused answer or the answer to a question that you did not ask, jump on it to undermine the credibility of the witness.

Ballentine suggests that the best strategy, if you run into these ambiguous queries, is to keep seeking clarification. "I would stop the interview," he says, "and say: *wait a minute. I'm the chief compliance officer, and I didn't understand that question. Could you try again?*"

In some cases, if the response still wasn't clear, he would simply ask what information the examiners were trying to get at. "I said, *just*

tell me what you want to know, and then we'll figure out how to get it for you," he says. "But it was still a struggle, right up to the end. It really felt like they wanted to catch us in a lie."

Beaudin says that his examiner team tried to trick him right out of the gate.

The SEC is requesting that client data be provided on a spreadsheet in a consistent format, suggesting that they've developed an AI bot of some sort to analyze this information.

"Turns out some gold bug guy in Nevada had been using my name in a testimonial, and I had no idea that was happening," he says. "He was using the names of a bunch of NAPFA officers, and he had just stripped our names off of the NAPFA website to create fake testimonials."

So the examiners initially inquired if Beaudin was doing anything with gold. He said no. They asked, *do you know this guy?* He said *no, I've never heard his name*.

"So we did a back-and-forth on this," says Beaudin, "and then they showed me this person's marketing materials—and they said, *well, how do you explain this?* They thought they'd caught me engaging in some outside activity, because this was clearly some commission gold thing that this guy was engaged in." It took additional explaining before the examiners backed off.

Richard Salmen, of the Family Investment Center in St. Joseph, MO and Lenexa, KS, had a different awkward experience with the examination staff. His firm's CCO had left less than a year before the audit commenced in October, and that seemed to provide a bone for the auditors to chew on.

"They asked a lot of questions about how we decided who our new CCO was going to be, and made a lot out of the fact that he had only been on the job for a year," Salmen says. "They tried to go down the path of insinuating that we really didn't have a compliance program, that we had outsourced all of it to MyRIACompliance [the firm's outside compliance consultant], and that it was all just a canned program. We had to explain, several times, that MyRIACompliance is not our compliance department. They do our cybersecurity training every month, and we bounce things off of them from time to time, but I showed them how our internal compliance folks meet with me before every quarterly executive committee meeting, and we give a report, and it is in the minutes of the meeting."

Document requests

In general, the examiners' document requests seem to have been fairly consistent from firm to firm: they want to see your firm's organizational chart and employee list; a list of your outside legal counsel and external compliance consultants; your advisory agreements with all clients; your form ADV Part 2B; your written compliance policies and procedures; the notes from your regular compliance reviews and any client consultant reports; any client complaints and litigation or arbitration proceedings; your firm's financial records; all marketing materials; all third-party standing letters of authorization (SLOAs); best execution reviews; and finally the big kahuna: an Excel spreadsheet that lists, in a specified format, all of your current and former clients with their account numbers, balances, investment objective for each client, whether the advisor has discretionary authority over the account, whether or not fees are paid directly from the account, account values, and the holdings of every account with CUSIP numbers, plus your trade blotter.

I found it interesting that the examiners, in all cases, insisted that this client account and trading information be provided on a spreadsheet in a specified format. An educated guess would be that the SEC has developed, internally, some kind of automated analytical protocols, where an AI-like system can sort through the client data so long as it is in a consistent spreadsheet format, looking for things like higher-cost fund share classes, discrepancies in fees from client to client, discrepancies

between the actual fees charged and what the ADV says, and generally the level of trading activity. This automation may explain why the SEC is suddenly able to be much more efficient and audit more RIA firms in a given year. (One recent report says that 15% of advisory firms will be audited by the end of the year.)

Interestingly, different audit teams were giving out inconsistent deadlines to produce the documents on their list. Salmen received a call on a Monday and was expected to produce the required documents by Friday. Kaplan was given a week to meet the document request—during the worst of the market downturn. Brown and Foster were given two weeks to produce their documents and records. Dave Ragan, of Grunden Financial Advisory in Denton, TX, was contacted in the relatively calmer period of late July, and was given a full month to pull together the 27 items the examination team requested.

Advisors consistently said that the client portfolio data was the most time-consuming thing to produce, followed by the SLOAs. But in today's high-tech world, much of the heavy lifting for getting this information can come from your custodian and/or your client performance reporting software. But if you haven't experienced a remote audit, you might consider checking with your provider to make sure that process will go seamlessly.

Be prepared to be surprised. For some years before his audit, Ballentine had familiarized his staff with the index of books and records that the SEC expects RIA firms to maintain, which is available on the SEC website. "We use that document internally to test ourselves at least annually," he says. "The challenge I put to our team is: *here is the SEC's document request. We have to show that within a matter of two days, from now, we could produce every single thing on the list, without any sweat*."

Advisors consistently said that the client portfolio data was the most time-consuming to produce, followed by the SLOAs.

Initially, that meant reorganizing the way records were kept and creating new reports. But after years of honing the process, the bottom line is that it worked. "There was only one thing we didn't have, because it was new," says Ballentine. "They wanted us to break down custody by discretionary and nondiscretionary assets, which was something they had never before asked about."

When his firm shifted client reporting vendors to Black Diamond, Ballentine was surprised to discover that his new reporting software didn't have the push-button reporting functionality that he needed. "They wanted to charge us to build it," he says. "And we told them, *we're not paying for this. You're marketing to RIA firms. You've got to have this. Right now, you're lacking credibility because you don't have this stuff*."

Fenn reports that when he asked Tamarac for the reports in the format that the SEC was requesting, the provider wasn't able to give him a push-button solution. "We had to go back and forth with them a number of times," he says. "We couldn't get one report to produce everything we needed, so we ended up exporting three separate reports, and then we copied and pasted into the spreadsheet to create the one spreadsheet that the SEC wanted to see."

Salmen says that he asked Orion about the SEC's client account request and got what he needed. "We told them we didn't have the exact report that we needed, and they said, *oh, no problem. We've got that report already built, because we have advisors getting audited all the time*. They produced a huge spreadsheet that covers all 1,300 accounts."

Other advisors turned to their custodians for the requested account information, and surprisingly, none of them told me that they were able to produce every bit of the required information programmed in a neat report. Kaplan discovered that TD Ameritrade couldn't provide the CUSIP symbols for her clients' bond holdings, and otherwise there were times when she had to create, by hand, separate columns for

holdings that weren't shared by all clients. "There was a lot of cleanup that I had to do in augmenting the TD Ameritrade files," she says. "I spent maybe ten hours cleaning up and fixing those files over a weekend."

Foster had a similar experience. "The document request, among other things, asked for all the trading activity over the past two years," she says. "So we called Schwab, our custodian. They were able to get our data into the format the SEC wanted for seven of the items, like new account agreements and the date of every trade. But there were three other columns where the staff had to grab those documents manually and merge them into the spreadsheet."

Not every custodian, and not every portfolio performance software company, is equipped to deliver the information the SEC requires.

Such as? "We had to add the client account name based on the account number, and we had to add security names based on the CUSIP and ticker," says Foster. "Schwab had this information, but it wasn't available in one export function."

Beaudin relied on Orion to produce his spreadsheet, and in his exam there was evidence of those AI-like analysis capabilities.

"Among other things, we had to produce our trade error report in our compliance execution log, which we recap each quarter," says Beaudin. "They came back and asked about a particular trade error, and said there was no record of that one particular error in the client record. They somehow had gone through every single transaction for two years, and couldn't match up the trade error with anything in the client's record." (This particular error happened to work in the client's favor.)

In another case, the SEC found that one client was missing a 'Portfolio Mission'—Beaudin's term for an investment policy statement. Another client was missing a signature document. It seemed to imply a level of scrutiny that must have been automated to some degree.

Brown's staff had to manually add client 401(k) accounts to the report from Tamarac, and then manually add the CUSIP of every item that was traded. "My trading person had to look up the CUSIP that was associated with all the ETFs," he says, "because Tamarac doesn't keep track of CUSIPS."

Policies, procedures, ADVs

In every audit, the SEC examiners would read the RIA firm's policies and procedures manual and then ask for documentation that the procedures were being followed on a routine basis. Ragan says that his firm fell short in this inspection. "They asked us to prove regular testing of what was in the manual," he says. "We have a compliance consultant who we can ping if we have questions, but we maintain our compliance manual in-house. Our approach had been, a couple of times a month, we'd sit down and read a full section from our compliance manual and see if it needed to be updated. If a scenario came up with a client, we'd look at that section and see if we needed to make changes."

This, alas, was not good enough for an SEC auditors. "They were looking for something more proactive," says Ragan. "They wanted us to show that we were reviewing the email correspondence of advisors, and taking a random selection and testing of client billing—things like that." The firm now has the outside vendor randomly select emails for review, and the client recipients of those emails—randomly generated—will be checked for trading and billing issues. "It's a quarterly testing procedure," says Ragan, "to test and monitor and make sure we're following our policies."

Kaplan was told that she had to remove an item on her ADV where she said that her firm doesn't give advice on Roth IRAs. In fact, one client came in with a very large Roth account and small other accounts, and she did offer some advice on asset allocation. The SEC demanded that she remove that contradicting disclosure from the ADV.

Ballentine reports that the examiners in his audit wanted to see all the notes of all the compliance meetings—and he says

that ideally you should be able to produce a lot of them. His firm holds compliance meetings every two weeks, and every meeting has an agenda, meeting notes and follow-up notes. "That was 75 big computer printout pages of very fine print," he says, adding that when the SEC finally reviewed those items, the tone began to shift to something a bit friendlier.

"My advice for anyone preparing for an SEC audit," Ballentine adds, "is to have lots of agendas, and lots of notes, and write up any problems you find and how you fixed them. For us, that paid off."

Are your policies and procedures in paper or electronic format? Brown's firm had bought a customized policies and procedures manual from Stark & Stark, and immediately printed it out, put it in a binder and over the years updated it in paper form. "We would pull our best execution reports, and agreements, and confidentiality agreements with vendors," says Brown, "and most of the time it's easier to three-hole punch them and put them in a binder."

Big mistake. The SEC requires everything in electronic format. "Scanning everything was a big pain the butt to do," says Brown. Lesson: it's better to make your policies and procedures manual a living, ever-adjusting Word document.

What's your 'pandemic policy?'

Every audit looked at the advisory firm's disaster recovery plan, particularly in light of the ongoing pandemic disaster that was forcing the SEC to conduct remote audits. "In a followup request," says Beaudin, "they actually asked us for our 'pandemic policy.' Of course, our response was that we didn't have a specific pandemic policy. We feel like our business interruption policy covers things including pandemic."

Make sure your policies and procedures manual is in Word format. The SEC requires an electronic copy.

Cybersecurity was a big issue in Fenn's examination. "They wanted to see how we executed our business continuity plan with COVID," he says. "How were people working from home, and how were we protecting client information? With nobody in the office, what happens to confidential client information that might be in filing cabinets?"

Carolina Capital's cybersecurity chores are handled through RightSize Solutions, where you log into RightSize servers for remote access to all of the firm's software. That way, RightSize can monitor all activity—and protect access—through its own servers. "The examiners asked us a lot of questions about RightSize's role," says Fenn. "They wanted to see our contract with them. And they asked about password policies and procedures, and around changing passwords."

In contrast, Ragan's firm breezed through the cybersecurity part of the audit. "We have a local tech consultant who comes in to make sure everything is up-to-date," he says, "and another outside vendor monitors our network traffic, and periodically does a penetration test to see if they can get in." The firm gave the examiners its monthly reports, with notes on adjustments that the vendors recommended, and confirmation that those adjustments were made.

Linda Lubitz, of the Lubitz Financial Group in Miami, FL, got off on the right foot regarding cybersecurity with the very first communications. "The SEC has this secure website that you have to log into, and give all your information back and forth through that avenue," she says. "They kept sending us emails through that server, and the emails kept getting bounced back, the emails for me to set up my account on their system. It turns out," she adds, "that our firewall and spam protectors were so strong that they wouldn't let the SEC emails through. So we had a laugh about that; that maybe they didn't need to check our security system, since even the SEC can't get through it."

Even though Beaudin's firm had gone through a recent cybersecurity audit, the examiners spent a big part of their time on the firm's cybersecurity policies

manual. "I learned that they really hate to see the word 'may,'" says Beaudin. As in: the firm '*may*' conduct quarterly tests, or the firm '*may*' do a nightly backup, and '*may*' review policies within a certain time period. "The cybersecurity policy that we were provided with had 'mays' all over it, and they didn't like that at all. They said, *tell us what you do, and if you don't do it, don't put it in there*. We had to do a revision on the fly and give them an updated edition of the cybersecurity policy that didn't include any of the 'mays.'"

Ballentine found that the SEC examiners seemed to assume that his whole business was nothing but managing money.

Fee discrepancies

Giachetti spent almost a quarter of his presentation on fee discrepancy issues. But what, exactly, are the SEC auditors flagging in real-world examinations?

I talked with the CCO at a multi-custodial firm with multiple offices whose advisors bill AUM fees in advance, and he told me that he wished that, before the audit, he could have had everybody on a platform like Envestnet, Orion or Black Diamond. Why? Those platforms would issue rebates or otherwise automatically adjust billing based on new money flowing in and out. Otherwise, in his case, there were many small discrepancies which took literally half the exam time for the SEC to sort out. My takeaway from that is that you probably should avoid billing in advance, and the problem goes away.

Will Casey, of Access Investment Advisors in Manitowoc, WI, reports that the SEC noticed that he was charging different rates for different clients, and as soon as they saw that they dug in hard. "I said, *yes, in certain situations, we elect to have lower fees, based on the amount of activity that we're doing for the client*."

The examiner replied that this obviously meant that fees were negotiable, and that should be stated up-front in the ADV.

"I said, *they really aren't*," says Casey. "*This was a decision that WE made after looking at client situations. We didn't ask the clients how much they wanted to pay or anything; some client situations are obviously more complicated than others*."

Ultimately, Casey lost the argument and was forced to state, on the ADV, that the firm's fees are, indeed, negotiable.

Ballentine says that the SEC examination team dug into client billing very carefully in his audit. "They seemed to assume that our whole business was nothing but managing money," he says. "They were trying to find fault with the scope of work for clients. For instance, they would look at a client situation and say, *well, when did you last trade this account?*"

Finally, they zeroed in on ten of his clients, and asked to see all the correspondence and work product for those ten clients. The emails and CRM dump of all the tasks that were completed on behalf of those ten clients were sent in through the SEC's secure website, and it wasn't long before Ballentine received a call from the head examiner.

"He said: *you must have misunderstood*," says Ballentine. "*We don't want the correspondence and work for ALL your clients. Just ten*.

"I said: *we only gave you ten*.

"He said, *oh, my god, the volume of stuff!*

"I said: *I tried to warn you*.

"He said: *you don't understand. When you send us stuff, we're required to look at all of it. We can't decide not to look at it. I'm going to have to have one of my guys spend days going through all that*. I hung up the phone laughing," says Ballentine.

Fenn says that the SEC cross-referenced fees with account values across his client list, and then asked about a discrepancy in the smaller accounts, where the firm had been charging a flat fee that was larger relative to the account value. "We had to explain that even though we are managing the money," he says, "the fee also includes financial planning and some business consulting that we were doing for those clients."

So the SEC asked for the work product for that group of

clients. "We sent them our plans and correspondence and everything we had done for those people for the last ten years," says Fenn. "And they never had a followup question after that. I remember that as I was putting it all together, I was thinking that the SEC was going to come back and tell me the price we're charging is pretty low relative to all the work we've been doing."

The implication from these stories is that the SEC is not equipped to judge the quality of your work product or the appropriateness of the amount of advice and planning work you're doing on behalf of your clients. But they seem to be impressed if you send them a big volume of documents, work products, tasks completed, etc.

Share classes and models

Every advisor I talked with said that the examiners asked questions about share classes, but not everybody had the same experience with the topic.

Beaudin, says that his firm has been pretty strict about recommending only ETFs or institutional share classes. But the report generating process turned up 200 holdings of more expensive fund shares that had been in client portfolios prior to the relationship. "They were all little bits of dollar amounts, shares that we inherited, not things we recommended," says Beaudin, "and they didn't seem to be interested in digging into that."

Casey had a harder time with the examination of his share class selections. "They went through our trade blotter and found that we had multiple share classes of the same funds," he says. "And they just locked onto it. They said, *you are not using the lowest-cost shares in all cases*. They kept looking for some kind of compensation flowing from these different share classes into our pockets, and I tried to assure them that that was not the case."

Casey explained that some less-wealthy clients were adding or taking money out of their accounts on a consistent basis, and so he had decided it was less expensive to use no-transaction-fee share classes for those client situations. "If a guy is taking out $500 a month," he says, "we're not going to whack him with $20 on every transaction. And the same thing with money coming in."

In other cases, clients had come to the firm with legacy positions with sizable embedded capital gains, and for some of those, the fund firm wouldn't permit an exchange to institutional shares. "In our response letter," says Casey, "I said that we would not be doing our fiduciary duty if we did it the way they wanted us to do it, to use one share class for everybody regardless of the circumstances."

The result? "They came back and said they wanted to see how we handle the share class decision in our policies and procedures manual," says Casey. "So we added a formal methodology in writing."

Some of the examinations—but not all—looked at the appropriateness of client portfolio asset allocations. But you have to wonder how the auditors made their judgments—if they did. Fenn reports that the SEC wanted to see meeting notes and backup information on how the firm selected the appropriate portfolio model for a random selection of different clients. "Once we provided that documentation, I didn't get any followups or blowback," says Fenn. "But I would recommend that everybody keep in mind that they might be asking about those things sometime in the future. The day is coming when they're going to want you to justify why your client is in that particular model."

At this time, the SEC is not equipped to judge the quality of your planning work or the appropriateness of the amount of work you're doing for your clients.

Foster discovered something interesting during her audit process. Her firm pools client assets into LLCs, so that they can, collectively, meet the minimum investment in private real estate portfolios. "One of the examiners' big probative questions around those investments," she says, "Was: *who is the client? When you do that, who is the client?*"

You might think the right answer would be the actual living, breathing clients who have invested in those programs—right?

"The actual answer is that the LLC is the client," says Foster. "Our grouping of investments is the client, not the owners of the LLC. The clients are members of the LLC, but in those investments, the LLC is your client. That was a big deal to them, and they wanted disclosure of that fact--plus all the information about all the investors in the LLCs."

The SEC also asked for the corporate minutes for all the LLCs over the years—so anybody who pools client investments should make sure they are keeping up with that chore.

Custody and discretion

A lot has been made about the SEC's definition of custody in recent years, but there still seems to be some confusion about how to determine whether you have custody and how you handle the surprise exams. Fenn says that the examiners spent the most time asking which accounts his firm had custody over, and the results of the annual exam. "We had to give them the results for ten years," he says. "And they were very interested in the kinds of records we were keeping for those accounts that we have custody on, and they delved into the client login credentials."

Specifically, they were looking at the level of access the firm would get from the logins, what the firm could and could not do. "The followup," says Fenn, "was: *'Please indicate if the firm is able to disburse funds from the account, and to what extent funds can be disbursed.'* It then went into: *Can you change addresses?*"

Of course, different plans allow the plan participant who logs in different levels of control over the account. "I was under the impression that as long as we can't move money around without the client being notified, we didn't have custody," says Fenn. "To get our hands on the money, we would have to file fraudulent paperwork, change an address, have the money sent to my home address—and each time the client would receive notification."

The SEC takes the position that you have custody of client assets if the SLOAs allow you to move assets from a client account to a joint account.

Fenn discovered at the end of the examination process that the SEC took a different interpretation. "They said that they are going to treat having client login credentials as having custody," he says. "They didn't say we couldn't have login credentials," Fenn adds. "They just said, if you have login credentials, you are going to have custody, and you need to include those accounts in the surprise audits."

The SEC asked for all of Grundon's SLOAs and then wanted to see the records of cash disbursements. "Technically," says Ragan, "under the SEC's definitions, we do have custody because the standing letters of authorization say we can move client money out of an IRA in Bob's name to a checking account that is community property with another owner. But, he says, the SEC didn't ask for the firm's surprise custody audits because the firm had processes to verify and confirm that it was never the intended recipient of the SLOAs, nor was it ever the recipient of client money. "The examiners didn't give us a hard time about it," Ragan reports.

Ballentine has decided to embrace custody rather than fight it. "We have taken the position that we have custody of every account," he says. "That completely eliminated the risk that the SEC would say: *well, you didn't report that account over there, and we are going to write you up for that*." He adds that this is 180 degrees from his initial thinking on the subject. "It used to be we would minimize the number of accounts that we had to report custody of, because it was somehow bad to have custody," says Ballentine.

His firm doesn't touch client bank accounts or pay bills on behalf of clients. But it does facilitate the movement of cash and securities from accounts in one name to joint accounts, and sometimes routes money to the escrow agent to buy a house.

The custody becomes significant due to a check and balance that Ballentine has initiated whenever it prepares a document for clients to sign authorizing the transfer. The firm will deliberately leave out personal information until after the form is signed and

sent back. "If you send a signature-ready form that the client can print out, sign and scan and send it back, if there is a criminal anywhere in the loop," Ballentine explains, "that criminal now has access to the fully completed form with the client's signature on it." He prevents that by sending forms with critical information missing, and then filling in the missing information when the forms come back, which are then transmitted to the custody agent over a secure link. "Much safer," says Ballentine.

Brown's firm also takes the position that it has custody, and submits itself to the annual surprise audit. "We keep a spreadsheet with all the logins and passwords," he says. "It allows us to pull off a copy of the client's 401(k) statement or an annuity that they were sold, for our portfolio reports."

Interestingly, Brown's interview makes clear why the SEC asks for the standing letters of authorization. "We had TD Ameritrade break down our SLOAs in terms of whether we could move money to an external bank account," says Brown, "and they will break it down in terms of ACH and wires." The SEC looked at whether the firm can direct the distributions electronically, and whether they can change the account names, addresses or beneficiaries electronically.

"Whenever we can do one of those things," says Brown, "we send that client's name and information to the surprise auditors, and they pull off a sample of eight or ten for their evaluation."

The SEC's automated system apparently compares the SLOA data with the surprise audit data. "The SEC wanted to know, of our surprise audits, which clients we sent over last year, and the year before, and the year before that," says Brown. "Then they came back and said, *why didn't you send these three people in this or that particular year?*"

The answer in a couple of cases was that the clients had retired and rolled their 401(k) assets to an IRA. One client had died. Another had severed the client relationship. It's a question that many advisors will need to be prepared to answer.

Claims, awards & advertising

Ballentine Partners' website included a note stating that Ballentine was one of the profession's earliest comprehensive fee-only planners. "I thought that was a true statement," he says. "At the time I started, NAPFA had fewer than 100 members in the entire U.S. I was the only fee-only planner showing up anywhere in Maine, New Hampshire, Vermont and Massachusetts."

So when the SEC flagged that comment, Ballentine explained his position.

"They came back and told me, *well, you can't prove that*. So I gave up," Ballentine says. "*Okay; we'll take it off.*"

Fenn says that his examiners asked for copies of any message that was sent to more than ten clients (which the SEC defines as advertising, even if the messages didn't get out to prospects or the outside world), and every message that was sent to five particular clients that they selected. Nothing came of it.

The more marketing a firm does, the more SEC scrutiny it will receive. And the SEC will inquire about any awards that appear on your website.

Not surprisingly, the more marketing a firm did, the more scrutiny it received. Like most advisors, Ragan was asked to provide all of Grunden's marketing materials over the past two years, which turned out to be a chore. "We had started advertising Social Security workshops on Facebook, and we had done a lot of email blasts," he says, "and sometimes there were just a couple of words changed on the Facebook ads to see if they would get more clicks."

That was difficult but didn't trigger any additional questions. The examiners did, however, question the mentions of various awards on the Grundon website: D Magazine 'best firm;' Investment News '40 under 40,' '5-star wealth management' and, Ragan says, a couple of others.

The SEC didn't question whether the firm had actually won these awards, and the wording of the disclosures was not a problem. "They said that our disclosures weren't physically close enough to where we mentioned the awards on

our website," Ragan says. "That was an easy problem to fix."

Lessons learned

At the end of every interview, I asked the advisors what they learned about their remote audit process, and what advice they would give other advisors who may not realize they're about to get that virtual knock on the door. The answers tended to be consistent.

Be prepared to control your emotions if the examination becomes emotional. And understand that the examiners may ask for things you've already provided.

"The preparation was really important," says Ballentine. "Practicing the data access made it so much easier for us to produce the things they asked for." He adds that you have to be prepared to control your emotions if the conversation becomes adversarial. "The fact that they seemed to be really bad at asking questions, combined with their lack of understanding of our business, that was really scary," Ballentine says. "The combination of the possibility of us misunderstanding a question, and not being able to point that out to them after the fact, and their lack of understanding our business, just felt like an explosive mix."

Like Ballentine, Foster found herself dealing with confusing requests. "In any communications," she says, "the first thing you have to do is interpret the question, and get clear about what they want."

Ragan recommends that you not instantly, instinctively respond to the examiners' verbal requests. "They'd ask for something, and I would ask them for a day to make sure I got them what they needed," he says. "I would recommend that advisors give themselves some breathing room to prepare for whatever topic they bring up, rather than taking a call and trying to send something two minutes after they made the request. The examiners were okay giving me an extra day to gather my thoughts and be prepared."

Several advisors told me that they preferred the remote process to having a team of examiners in the office. "It gave me more flexibility to get our manual up on my screen while they were asking questions," says Ragan. "I could reply more accurately with those resources at my fingertips." Adds Brown: "In our audit back in 2013, they sent their whole team in here and parked people in my conference room for a week, which was very disruptive and unnerving. This time," he says, "it was three two-hour interviews on the phone."

Foster is grateful that she and her staff had prepared in advance for something that many advisors will be surprised by in their audits: the SEC examiners will issue followup requests for information that has already been provided. "My office manager created a coding system for every document that we sent over to them," she says. "So we could refer directly to audit question 66, item A, sub-item 2, sub-sub item aaa, and so forth. If they asked for something we'd already provided," Foster adds, "we could refer them to what we'd already sent. And I think when they saw that, they realized that they were dealing with an organized firm."

Lubitz says that you should try to find a balance in your communications. "I wanted to have a human connection with the examiners," she says, "so they would see that we have nothing to hide, and that we're a professional firm. But there's a fine line," she adds. "You don't want to seem like you're sucking up. I just wanted to communicate our culture to the SEC examiner that we are fiduciaries and that we take seriously running the office efficiently."

In general, what the SEC seems to be looking for is whether the firm is diligent about keeping up with its records and protecting clients in meaningful ways. Salmen says that his time in the military helped him develop the mindset needed to prepare for "inspection" by the SEC.

"When I was an army officer for 14 years," he says, "I used to shake my head at the units that would start preparing for an inspection when they heard it was coming—versus running everything right to begin with, and using good procedures. If you don't treat compliance as something you do once a year," he says, "then you'll be ready when you have an audit." ■

3-Dimensional Client Assessments

Synopsis: ***How do you define your clients' risk tolerance in conjunction with their risk capacity?***

Takeaways: ***Monte Carlo calculations are a blunt instrument for evaluating the changing market regimes, timing of capital needs and evolving correlations.***

Michael Kitces has written about the three factors that should, ideally, go into determining the 'right' asset allocation for a client portfolio (*https://www.kitces.com/blog/risk-tolerance-questionnaire-and-risk-profiling-problems-for-financial-advisors-planplus-study/*), and noted that most advisors tend to focus on only one of them. There are a lot of risk tolerance tools in today's marketplace; the still-collecting-data T3/Inside Information software survey (*https://www.surveymonkey.com/r/2021SoftwareSurvey*) lists 14 (and counting).

The second factor is risk perception, which might be described as the variability factor in risk tolerance. In the relaxed atmosphere of an advisor's office, when the markets are chugging along as normal, clients might give answers that would suggest they're totally comfortable with a risk-on mix of assets. But in February of 2009 or March of 2020, when their net worth is dropping like a stone, they might give a very different profile—because they expect more downside than they did back when they took the risk tolerance instrument in the first place. The solution there is to give clients a risk tolerance assessment every once in a while—which, of course, most advisors don't do.

But what about the third factor that Kitces says that advisors should consider: risk capacity? It's obvious that if a client has $100,000 set aside for the down payment on a house that will be sent to the escrow agent in a couple of months, that part of the portfolio should be invested in cash rather than oil futures. But what about a client who has that upcoming down payment, and in a few years the first child goes to college, and a couple of years after that the second child needs a tuition payment, and the couple plans to retire in 25 years and has a certain monthly lifestyle cost that will fluctuate depending on changes in the inflation rate, and there's a vacation home in the future?

> ***How do you factor in risk tolerance, risk perception and risk capacity into the same portfolio?***

Add in the regular fluctuations in the market (and the value of the client portfolio) and, well, most advisors use a Monte Carlo analysis on their recommended portfolio that matches a client's risk tolerance and, if the sufficiency odds seem low, they advise the client to save more or retire later.

Mark Friedenthal, proprietor of a software program called Tolerisk Pro (*https://www.tolerisk.com/*), finds this Monte Carlo solution to the risk capacity problem to be very unsophisticated. "A lot of people don't need to take as much risk as they're willing to accept," he says. "With many clients, there's a clear mismatch between how they score on a risk tolerance instrument and the risk they need to take to achieve their goals."

He offers the simple example of a 30-year-old client whose risk tolerance score might indicate a very low-volatility portfolio, so the advisor puts her in an all-bond portfolio. "At age 90, that person might have a 32% chance of having retirement assets, because she's not protected from inflation," says Friedenthal. "Her primary risk is not a market contraction. It is that stuff is going to cost more, and she's not earning enough over time to compensate for it."

This same result might also show up in planning software. "In most cases with that situation," says Friedenthal, "the advisor would say, *well, you need to take on more risk*. And he shows that with a higher equity portfolio there is a higher expected return over the long run,

and that magically diminishes the probability of failure," he adds,—though it may increase the variability of outcomes.

But then, Friedenthal points out, a portfolio outside the client's comfort zone makes behavioral risk much more likely. The client might bail out of the allocation when the market goes down.

The traditional Monte Carlo approach doesn't take into account the timing of monies that will need to be withdrawn, or the chances of success on any particular goal.

Moreover, the traditional Monte Carlo approach doesn't take into account the timing of monies that will need to be withdrawn. "There are really two independent dimensions to the risk problem," says Friedenthal. "One of them is completely mathematical. We can mathematically measure someone's ability to take risk using an objective scale that relates to the ratio of stock and bond allocations, where we show that a mix of these assets and these volatilities have a probability associated with achieving a particular mix of future withdrawals."

The other dimension, of course, is the clients' willingness to take risk. Friedenthal doesn't use the word "tolerance" because 'willingness' is the term the SEC uses in its quantitative descriptions.

If there is a third dimension, it is how the willingness and the ability to take risk interact, mathematically, to produce an appropriate portfolio. As it turns out, this last problem is the easiest of all.

Monte Carlo limitations

On his LinkedIn page, Friedenthal describes himself as a 'math nerd,' and his background suggests that he has fully lived up to this self-characterization. After graduating from Emory University in Atlanta, Friedenthal spent several years at the Atlanta Fed, building mathematical models in asset/liability management and modeling related to the banking industry. That was when he began exploring the limitations of Monte Carlo mathematics—specifically, that they are not optimal for long-term projections.

Friedenthal took his mathematical expertise to a management position at GE Capital, where he was tasked with creating risk management models, and then later he was hired away to manage billions of dollars in company assets at a proprietary trading desk at Citigroup. In 2009, he left to start his own asset management firm, Friedenthal Financial, as a way to offer the same institutional asset management models to Main Street investors. "I thought that people with $250,000 to invest would want the same math, data-oriented, technology-driven processes that we had at Citigroup," he says.

Working with individual investors brought Friedenthal back to pondering the limitations of Monte Carlo analysis, and how to provide his clients with appropriate portfolios using math instead of instinct.

"If I were measuring some complex derivative instrument that has an expiration of six months, I'm going to want to use the most current information, the most current relationships, of whatever could be contributing to it," he says. "And I'm going to simulate a whole bunch of different paths for those six months, and I'll get a value for that instrument, as well as the sensitivity."

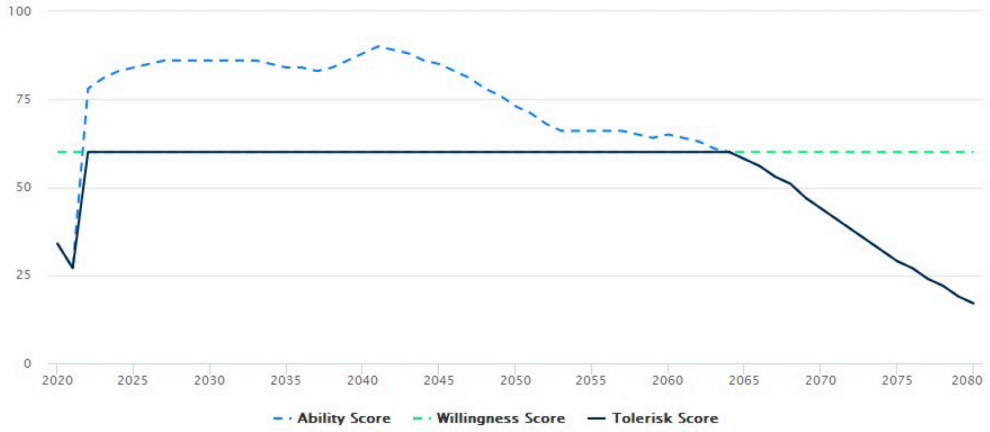
But with a financial plan, he says, you might be simulating three, four, five or more decades. "That's a very long time to implicitly make assumptions about a constant volatility or a constant correlation," says Friedenthal. "I've asked advisors: *do you think that volatility in the stock market will generally remain constant?* Invariably, they will say *no; sometimes it is very volatile, sometimes not volatile at all*. So then I say, *what about the correlations between the broad stock market and the broad bond market? Or the stock market and inflation? Or the bond market and inflation? Do those correlations remain at a constant level?* And then," says Friedenthal, "I'll ask them: *does your planning process account for that?*"

What's better? Start with the first dimension, Tolerisk Pro's risk tolerance (willingness) assessment, which is structured as a psychometric profile like FinaMetrica rather than

a comparison of different portfolios where clients pick the one they prefer over and over again, like Riskalyze. I didn't see anything much different about the 20 questions that Tolerisk Pro asks clients than you would see in the FinaMetrica assessment tool; both probe whether someone is a natural risk-taker (or not) in general life decisions, with frequent references to investing. (Sample questions: *I would rather earn half the return on an investment if I knew I could not lose any money. I feel anxious after I make an investment decision*.)

7. Projected Tolerisk Scores

The Projected Tolerisk Score through time is an estimate of how your Ability Score will likely evolve through time as you move towards and through your cash-flows. Your Willingness Score serves as a ceiling for your Tolerisk Score. Your Tolerisk Score is lower of your Ability Score and your Willingness Score at any given point in time.



This leads to a score ranging from 0 to 100, and that number becomes the percentage of client portfolio assets which, in this first dimension, at least, could be allocated to stocks. If the Tolerisk Pro willingness score is a 34, that would imply a 35/65 portfolio, or maybe a 40/60. Advisors can obviously diversify this stock allocation among domestic and international, small cap, midcap and large cap, but the overall percentage of stocks is largely determined.

There are some checks and balances built into this. Friedenthal included some redundant questions in the instrument, to see if the client actually understood what was being asked. In one instance, a client answered '*rarely*' to the question "*I tend to overreact when financial decisions turn out poorly*." But then answered '*never*' to the proposal "*I usually adapt easily when things go wrong financially*."

"Those are pretty dichotomous," says Friedenthal. "So the system would flag them, so the advisor could have a deeper discussion." He adds that for most advisors, both spouses should take the risk willingness assessment, and then the advisor should ask whether they want to meet halfway or use the lower score as the baseline for building a common portfolio.

Math models

What about that trickier second dimension, the risk capacity? Here, the system gathers much the same client data that you might input into a financial planning program: ages of both clients; the value of their existing portfolios and which are taxable and which are tax-deferred; the amount being saved each month; monthly expenses; and (very importantly) the timing and amount of future big ticket items like college, wedding, buying a vacation home, funding a business—and, of course, retirement. You would add Social Security benefits, annuities or pensions or any other retirement income streams.

Then Tolerisk Pro applies a mathematical formulation to these various inputs, and what comes out is a graph similar to what you see here (*above*), which shows both the willingness and capacity score evolving over time. As a simple example, if somebody has to make that $200,000 down payment on a second home, then the risk capacity score would be lower before that payment was made (because you'd naturally not want to take a lot of risk on money that will be needed soon) than it is afterwards (when there's less need to hold an asset in or near cash equivalents).

The actual formula that takes into account all these variables is proprietary, but it is important to realize that, even if the clients' risk willingness doesn't change (and it may), the risk capacity changes over time, as goals are achieved and the cash is disbursed, and also taking into account the ever-fluctuating investment 'regime.' This accounts for something else that Kitces has talked about: the fact that future return expectations are lower when market PEs are high and bond rates are low, than they are when stocks

are dirt cheap and you can get real yield on Treasuries.

"We use what is really tantamount to traditional fixed income mathematics," says Friedenthal, "similar to the way you would measure a bond or a bond portfolio's sensitivity to interest rate changes and credit spread changes. We're using the same kind of functionality to measure all of the cash flows sitting underneath that financial plan. We can say: *this is the sensitivity that can be sustained and still meet these obligations with that very high probability*."

Monte Carlo simulations are good at capturing sequence of return risk under a constant volatility and correlation environment. But is that how the world works?

How does the system recalculate the appropriate portfolio when stock PEs and correlations shift? "There are concepts from institutional fixed income and derivatives math where you are measuring forward curves," says Friedenthal. "You can measure an implicit forward curve of something like interest rates based on today's interest rate curve. Conceptually, you could think about it like migrating towards and through the client's cash flows year by year, and recomputing mathematically what that ability to take risk is."

Even if Friedenthal is a bit cagey on the actual formulas (he said at one point in the interview that he's nervous that one of the risk tolerance competitors would simply steal them) you can see that this is very different from Monte Carlo mathematics. What Tolerisk Pro is graphing is similar to what many advisors are doing by hand. When the markets go down, you run the financial plan all over again and show clients that their chances of financial success dropped from 94% to 92%.

But there's another difference. In addition to variables like expected return and standard deviations, changes in yield curves and correlation coefficients, movements in market PEs etc., Friedenthal's calculations incorporate inflation as an additional variable.

"Monte Carlo simulations are only simulating potential portfolio returns," he says. "They are not simulating inflation separately. They are really good at capturing sequence of return risk under a constant volatility/constant correlation kind of environment," Friedenthal adds. "We use a different mathematical process that allows us to capture evolving volatility, evolving correlations, we use a dynamic asset allocation that measures how the clients' risk ability mathematically evolves over time, a dynamic custom glide-path that is consistent with each client's very specific cash flow chronology, subject to their personality constraints, and the shifting inflation rate over time."

The mathematics create separate paths for equities, fixed income and inflation, and captures the evolving volatility between them, and then calculates real sequence of return risk relative to inflation.

There's one more variable that Tolerisk Pro takes into account: lifespan. The program uses unisex mortality tables (which advisors can customize based on client health data) to calculate the probability of a 50 year-old client living to age 51, 52 and so forth, all the way out to age 120, with an average weighted average lifespan for each client, and most importantly it calculates second-to-die mortality probabilities. The result is a calculated set of last survivor probabilities, year-by-year, which is incorporated back into the risk ability (capacity) calculations and the calculation of the odds that the portfolio will survive the longer-lived client in a paired relationship.

Avoiding behavioral mistakes

But that brings us (finally) back to that question that was raised earlier: how do you combine the risk willingness data on a client with the risk ability data?

If you look back on the projected Tolerisk Pro scores chart, you see that this involves mathematics that even a journalist could fathom. The risk ability score is the dotted line through most of the left side of the graph, while the solid line represents the risk capacity—which, as you can see, doesn't change over time. The risk willingness line serves as a ceiling

for the portfolio allocations; that is, clients may have more risk ability (capacity) than they are willing to take, but the system generally requires the portfolio to not exceed the lesser of the two.

"Everything is calculated over time," Friedenthal explains. The blue line starts out at a 34, it bottoms out next year at a 27 because of the capital expenditure to buy a house." Then, toward the right of the screen, the risk ability score suddenly drops below the risk willingness score, and that becomes the recommended portfolio allocation, and the risk willingness score becomes the dotted (over-ridden) line to the right side of the graph. "The dark line is where we set the cap," says Friedenthal. "Even though, mathematically, they have the ability to put 86% in risk assets, we are not going to recommend that because that would put them in an undue likelihood of making a behavioral mistake. It is beyond what we think they would be willing to accept."

When you combine everything, the overall Tolerisk Pro score in any given year is really the ability subject to the cap, the lesser of the two dimensions. And, in this particular case, when the second-to-die client reaches age 90, there is an 87% chance that, if the couple follows this glidepath, there will still be money in the retirement portfolio.

Alternatively, the system calculates that the money has a 95% chance of lasting to age 86 on this glidepath. And it calculates the probability of meeting each of the individual large expenditure goals as well. "If the chances of achieving Mary's college goal crosses a threshold, the system will highlight that," says Friedenthal.

"It all boils down, with all the fancy math, to simple outputs," says Friedenthal. "These are designed on the dashboard to answer the most common questions that advisors could field from their clients. *What do we recommend?* That is the Tolerisk score, calibrated to be the numerator in the stocks to bonds benchmark. *What is the likelihood that we will will run out of money with that initial portfolio?* After all the fancy math and moving parts, it boils down nice and simply to, in this particular case, there is a 13% chance that one or the other spouse will be alive after their money is gone."

At the moment, Tolerisk Pro doesn't have nearly the market share of some of its risk tolerance competitors, and after looking at the risk capacity (ability) features, one might argue that the program is mischaracterized in this category, and might be viewed more as a financial planning program. But whatever you call it, Tolerisk Pro has a small but devoted band of users.

"What we have found, anecdotally from advisors, is that their clients have a lot more confidence in the decisions that they make after using our software," says Friedenthal. "They see that the analysis is tailored to them, instead of just a personality questionnaire. It incorporates all their cash flows. Their mortality probability. College, some other goals."

And how does that translate into better outcomes? "The confident client sticks with the plan," says Friedenthal. "By measuring their ability, rather than just their willingness to take risk, it actually reduces the chances of a behavioral mistake."

In addition, for advisors who set up small business 401(k) or other plans, there's a Tolerisk Pro version that allows plan participants to enter information, where they would take a smaller psychometric test, and get a recommended allocation of the investment options offered by the plan and see online the odds of enjoying a sustainable retirement.

"We call that the Personal Asset Allocation Roadmap," says Friedenthal. "Instead of a target date fund, you have seven or eight different inputs plus a personality constraint that goes into the glidepath." The plan participants can play with the inputs—changing, for example, their retirement year from 65 to 68, changing the asset allocation, and the system will automatically calculate the employer match for different levels of monthly contributions.

The client has the ability to put 86% of the portfolio in risk assets, but the allocation is limited by the client's more conservative willingness score.

"The 401(k) version is for advisors who are working with small business owners, who have set up a plan as an accommodation," says Friedenthal, "but they're finding that giving individualized advice to so many plan participants is crippling them because they have to spend so much time on it."

Price? You can find a somewhat complicated pricing structure for the individual advisor version on the Tolerisk Pro website, but there is a free trial option, and then the highest price is $99 per user per month. (Firms with between 2 and 99 advisors would pay $89 per user, and there are discounts if you pay the full year in advance.) The program is cloud-based, and does not collect personally-identifiable investor information.

As I go through the Tolerisk Pro demo, I find myself wondering if it doesn't define an entirely new category of software. The risk tolerance component is just a piece of the much larger "appropriate portfolio analysis" puzzle, and it's interesting that the appropriate portfolio might evolve over time for clients who have different goals, different cash flow needs, and invest in evolving market "regimes."

The financial planning space has many examples of institutional mathematics making their way into mainstream client advice—Monte Carlo analysis is a great example of this. Tolerisk Pro's models might be the next example.

Is it time for the math-heavy portfolio analytical tools on Wall Street to enhance investment recommendations in the retail space? Time, as always, will tell. ■

Social Sophistication

Synopsis: ***A new book offers some down-to-earth advice on how to get the most out of LinkedIn marketing.***

Takeaways: ***Seek out individual conversations, and focus completely on them, without any personal agenda. When trying to connect with a reporter, adopt a mindset that you want to make that person successful by being an awesome resource.***

If you're like me, you've always been a bit mystified by the alleged "power" of social media. I've heard speakers talk about the importance of social engagement in your marketing programs, and after one particularly persuasive presentation, I rushed out to set up my own LinkedIn and Facebook accounts. The former attracted a lot of people in the profession who still don't seem to know who I am, and the latter ended up being a forum for people I knew in high school who seem to spend much of their time trafficking in some very creative conspiracy theories.

Your communications should be no more than two sentences. Anything longer forces the reader to scroll too much.

In all the articles and speeches telling me how important social engagement can be to my business, I've never seen anything that told me HOW to engage on these platforms, and what to expect when I did.

Until now. I've just finished a short (43 page) book on LinkedIn engagement by LinkedIn expert marketer Sara Grillo. Grillo is not only a marketing consultant; she's also a regular contributor to the *Advisor Perspectives* service, and has also taught advanced CFA classes in a previous incarnation. She wrote the book because she has, over the years, gotten so many (she is careful not to say 'stupid') questions about LinkedIn from people almost as clueless as I am.

What does she say? The book is entitled *"47 Financial Advisor LinkedIn Messages and Sequences"* (*https://saragrillo.com/product/47-financial-advisor-linkedin-messages-and-sequences/*) though it actually provides 54 messages in the text. I found the messages to be interesting and valuable in themselves, but I also got more comfortable with the whole idea of social media marketing by reading through the general advice that Grillo offered about the social media ecosystem.

For instance? I thought I should be posting longer articles and giving people detailed information. Grillo says that LinkedIn is primarily about communicating with people individually, and my social messages should be no longer than two sentences. (Anything longer than that forces the reader to scroll too

much.)

I thought that I had to market myself, or deliver marketing messages. Grillo says that the two-sentence messages, ideally, would consist of a statement followed by, in the second sentence, a question that invites engagement.

Grillo also says that it's okay to use emojis (you can get a bunch of them to copy and paste here: *https://getemoji.com/*), and in general you should try not to sound like a typical financial advisor or pitch yourself or a product. Your goal in every communication with individuals on LinkedIn is to find out what the other person cares about, has a problem with or generally is interested in. That may or may not lead to a meeting, but at least it shows that you're listening.

Grillo says that in all your messaging, you want to be curious, sincere, brief, giving and in general to reflect a sincere intention to make the other person's life better without attachment to any self-serving outcome. You should always be, Grillo says, focused on *them*, not on *you*.

From there, you learn about message sequencing, tracking your messages (the other party wants to see that you remember what you said in their last conversation with you) and when to drop someone from your list of correspondents. Later in the book, Grillo offers a number of potential sequences that you can customize to your own style, including a content sequence and a kind of introductory sequence.

So why (you might ask) do you need 47 (actually 54) messages using these simple principles? Because every person you interact with is different, and the messages cover a wide range of circumstances. Grillo recommends that you check out a person's page before you respond to a message, to see what they're about. And then the book delves into the actual scripts themselves, which cover everything from asking how the other person found you to their interest in connecting, to simply what's going on with them. Is there something they want to achieve professionally?

There are a few proposed messages for when you meet somebody and want to establish a LinkedIn connection, some tasteful compliments and even jokes that relate directly to the other's published career. (To a fashion executive who runs a fashion networking group: *"Do you have a fashion group for people who have NO fashion sense? Can I be the first member?"*)

There are messages that ask the other person what kind of information they're interested in in various specific ways, congratulatory messages, and some advice on dealing with "tough cookies" by suggesting that either the other person tell you why they connected with you in the first place or you will stop interacting altogether. (One of the ten: "*I don't want to be a nuisance. We've messaged about your IRA. Would you like to talk or should I just quit bugging you?"*)

Grillo also covers connecting with centers of influence and reporters, noting that reporters are usually much easier to form a connection with than COIs because they're constantly looking for people who can be a good resource for them. She recommends that you adopt the attitude that you want to make the reporter more successful by being there as an awesome resource whenever they need you. (Very good advice.)

In your LinkedIn interactions, you want to reflect a sincere intention to make the other person's life better without attachment to any self-serving outcome.

In her book, Grillo says that you should not take these messages literally, but instead customize them to your own communication style. Reading through the 43 pages one more time, I can see how some of the messages convey what I would basically want to say, but I can see a better way for me to say it based on who and what I am. That will be true for you as well.

But bigger picture, the book helps to demystify LinkedIn for advisory firms who are still trying to get their heads around the whole social media thing. LinkedIn is the most professional and business-like of the social platforms, and the least likely to attract all your high school friends who like to trade conspiracy theories instead of make their financial lives better.

I just checked out my own LinkedIn account. I have 3,175 connections and I have never once interacted with them. Maybe this is a good time to start. ■

Communicating Fiduciary

Hooray! Hooray! The CFP Board has released a model client engagement letter that CFP advisors can use with their clients, which outlines in some detail the nature of the engagement and the standards that the advisor will be held to while working with the client.

You can find the letter here: *https://www.cfp.net/ethics/compliance-resources/2020/11/sample-engagement-letters-for-financial-planning-and-financial-advice*) It points the client to the advisor's Form CRS and Form ADV, and outlines the services and "products" (?) that will be provided by the planning firm: cash flow planning; investment planning; retirement planning; and estate, gift and wealth transfer planning.

The letter lists the seven steps of the planning process as defined in the CFP Board's Code of Ethics and Standards of Conduct, and talks about selecting an appropriate custodian and providing timely performance reporting on assets managed. It offers a fee disclosure, which (alas, as you'll see shortly) describes an AUM arrangement with the fees stepping down over various thresholds. It discloses a couple of conflicts of interests (*The amount I earn from working with you depends, in part, on the amount of assets I manage for you…*) and lists some responsibilities that exist on the part of the client.

At the end, there are links to the SEC and CFP Board websites which might reveal any regulatory history that consumers might want to know about.

The alert reader will have already noticed that I gave the CFP Board two cheers rather than the usual three for this disclosure document. Why withhold the third cheer?

Because there is no mention of a fiduciary standard, anywhere in the document. I found myself scratching my head. Aren't CFP advisors required to hold themselves to a fiduciary standard? Doesn't the CFP Board, in its advertisements, trumpet the fact that people who hold the designation are required to act as fiduciaries?

So the question becomes: what should we add to this document? To answer that, we need to ask ourselves, what, exactly, does it mean to be a fiduciary?

After kind of a long back-and-forth, I have been convinced by Knut Rostad, President of the Institute for the Fiduciary Standard (*https://thefiduciaryinstitute.org/*), that the CFP Board, itself, could do a much better job of defining what we mean by fiduciary standards of behavior. This client agreement is just one more piece of evidence for this curious shyness on the part of the CFP Board.

I agree with Rostad that the definition of 'fiduciary' that we typically trot out—"put the clients' interests ahead of our own," is insufficient because it is not nearly specific enough. It's a decent start, but today we have brokers and people who sell annuities claiming that they're fiduciaries, because they believe their recommendations are in the best interests of their customers—and I would argue that their behavior falls short of a fiduciary standard.

The brokerage industry has argued that we can get by with disclosure of conflicts, rather than avoidance of them. If people actually read the disclosures, I might agree. In this actual world we live in, I think disclosures are a cynical way around the fiduciary standards of behavior.

What's better? Interestingly, the idea of a fiduciary is found all the way back in the Code of Hammurabi, which was written in 1754 BC. The relevant texts focus on a kind of brutal enforcement of a person's ability to trust someone else who is temporarily handling his/her assets:

Item 112: *If any one be on a journey and entrust silver, gold, precious stones, or any movable property to another, and wish to recover it from him; if the latter do not bring all of the property to the appointed place, but appropriate it to his own use, then shall this man, who did not bring the property to hand it over, be convicted, and he shall pay fivefold for all that had been entrusted to him.*

Item 113: *If any one have consignment of corn or money, and he take from the granary or box without the knowledge of the owner, then shall he who took corn without the knowledge of the owner out of the granary or money out of the box be legally convicted, and repay the corn he has taken. And he shall lose whatever commission was paid to him, or due him.*

Item 120: *If any one store corn for safe keeping in another person's house, and any harm happen to the corn in storage, or if the owner of the house open the granary and take some of the corn, or if especially he deny that the corn was stored in his house: then the owner of the corn shall claim his corn before God (on oath), and the owner of the house shall pay its owner for all of the corn that he took.*

Item 264: *If a herdsman, to whom cattle or sheep have been entrusted for watching over, and who has received his wages as agreed upon, and is satisfied, diminish the number of the cattle or sheep, or make the increase by birth less, he shall make good the increase or profit which was lost in the terms of settlement.*

Item 265: *If a herdsman, to whose care cattle or sheep have been entrusted, be guilty of fraud and make false returns of the natural increase, or sell them for money, then shall he be convicted and pay the owner ten times the loss.*

Notice that there are no provisions for "disclosure" of conflicts, where the owner of property entrusted to another signs a waiver saying that maybe the items will be lost or stolen while the other person has possession. The brokerage firms would have had a hard time doing business as usual in ancient Babylon.

You find a broader idea of fiduciary in the medieval Japanese culture, a strong thread of which survives today in the idea of maintaining your honor in business dealings. If a medieval Japanese samurai was found to have harmed others or society through ethical lapses, or behaved in a shameful way by benefiting himself over others, he was expected to ritualistically end his life. (Commit seppuku.) That may seem a big extreme to Western eyes, and ritual suicide probably should be left out of the CFP Board's sample document, but the concept of maintaining your honor is actually pretty strong among many financial planning firms.

Once again, disclosure is not an excuse. If we had a bit more of this kind of culture in the U.S., a bunch of brokerage industry executives would have bloodied the carpet in their offices using sharp ritual swords.

We want to be careful about loading any fiduciary definition with specifics, because we don't want to turn a principles-based regulation into a set of rules. But I think there are some clear guidelines that we could offer.

First, the sample document might tell the client that the firm will avoid conflicts of interest as much as humanly possible. Taking compensation for advice could be considered a conflict; that one is hard to avoid, so I would disclose it. But what about commissions—having the product manufacturer pay you to recommend its products?

I have, in the past, argued that advisory firms that take commissions cannot be considered fiduciaries—and the only successful pushback I've gotten is where firms recommend term life and take small commissions, and rebate them against their fees. But today there are no-commission term life policies, which would seem to eliminate that exemption. Could the document specify that the firm will not accept commission-based or third-party revenue?

What about brokers who gather assets for their company's asset management platform, or for the separate accounts that pay their company a shelf space payment (disguised as revenue-sharing)? If we're going to protect the public from predators, I think it would be necessary to impose a strict fiduciary standard here, and to require all compensation to be received directly from the client, not have the client pay the brokerage firm, which then pays a share of that to the broker. And I would especially view any variable compensation (the broker gets more for recommending these products than those) as a breach of fiduciary duty.

The goal is to finally, irrevocably, separate advice from sales. My recommendation there is not to change the disclosure document, but to require those who hold the CFP designation to accept only compensation paid directly by the client. If you're unwilling to do that, give up the mark.

Giving advice where you don't have the training or expertise is another obvious conflict. You don't want to give the client a recommendation to a professional because you want to gather all the fees or fear the other professional might steal the client relationship. I would argue that failure to recommend outside experts where appropriate is a breach of the fiduciary standard.

The disclosure document might be reworded to assure clients that, if a complicated issue arises

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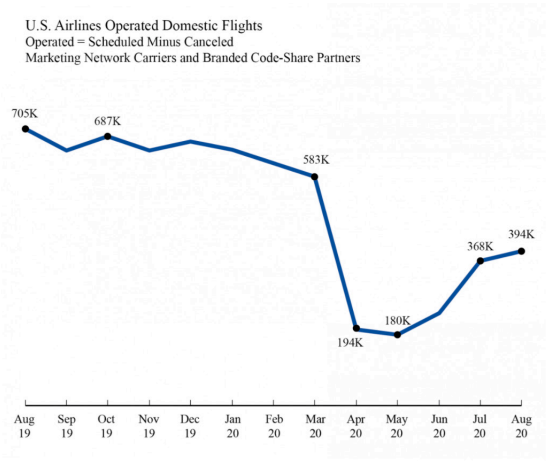
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outside the expertise of the firm, that the firm will recommend an outside expert in that area.

Finally, I think the profession is going to have to address the assets-under-management compensation structure, and recognize that AUM-compensated advisors are embracing unnecessary conflicts of interest. I ran into this myself when I went to visit a prominent financial planning firm, and wanted advice on some of my business arrangements. The advisor immediately wanted to see my account statements, and after burying his nose in my retirement accounts, recommended that I turn that money over to his management.

I timidly mentioned that I was looking for business advice, not asset management, but the planner simply would not let go of a focus on my assets, and eventually made managing them a condition of our relationship.

Of course, there are a variety of other conflicts embedded in the AUM revenue model, and you know what they are. My point is that these conflicts are seldom disclosed and even less often are they avoided by today's planning profession. A strict fiduciary standard would at least require disclosure. At best, it would require a revenue model that is directly tied to the advice given, regardless of the assets that the client brings to the table.

This would be a tough one for the CFP Board to address, but at the very least the sample client agreement should not automatically assume that the advisory firm is compensated by AUM. And if the firm's revenue model IS AUM, then I would like the CFP Board to include a sample disclosure of the various conflicts this entails.

Is there anything I've left out? I send these messages out to my audience in hopes that you will see things that I've missed, and you will educate me about my shortcomings. What else is needed in the client agreement, or more broadly in our bigger, more encompassing definition of 'fiduciary?' Together, we might help the CFP Board unravel some of the complexities around a true professional engagement. ■