



Ron Rhoades: If investment advice becomes a profession, demand will soar

## Part One: Investment Advisers: Is our path toward, or away, from a true profession?

### An argument for taking the high road

by Ron Rhoades, Guest Columnist

*Elizabeth’s note: Ron Rhoades, who has been called a one-man RIA think tank, provides this 30,000-foot view of the regulatory reform debates currently taking place in Washington, D.C., affecting investment adviser and broker-dealer regulation. Ron argues that investment advice should arise to take its place as a true profession and lists the six attributes of a profession later in the article.*

Often overlooked in the “debate” over fiduciary duties and their applicability to investment and financial advice is whether registered investment advisers constitute a true profession, and if not, whether they should. In my view, “investment advisors” are at best a potentially “emerging profession” and the future holds two distinct two paths.

The first path ends with investment advice dominated by commercial interests, with resulting lower standards of conduct applicable to the delivery of investment and financial planning advice. Under the alternate path the provision of investment advice arises to the level of a true profession, in which individual professionals collaborate to establish, maintain and over time enhance the bona fide fiduciary standard of conduct, all subject to a degree of government oversight. Which is the path our policy makers will choose?

### Why Investors Need Professional Advisors, Governed by a Fiduciary Standard

**Arms-Length Relationships.** Two types of relationships exist between product and service providers and their customers or clients under the law. “Arms-length” relationships apply to the vast majority of service provider – customer engagements, including those between registered representatives and their customers. In these relationships, the doctrine of “caveat emptor” generally applies, although this doctrine is always subject to the requirement of commercial good faith. Additionally, this doctrine may be modified by imposition of specific rules or doctrines by law, such as the disclosure requirements imposed by various securities laws and the “suitability” requirements imposed upon registered representatives.

**The Fiduciary Relationship.** The fiduciary relationship, in contrast, involves a relationship of trust. This necessarily involves vulnerability for the party who is reposing trust in another. In such situations one’s guard is down; one is trusting another to take actions on one’s behalf. Under such circumstances, to violate a trust is to violate grossly the expectations of the person reposing the trust. Because of this, the law creates a special status for fiduciaries, imposing duties of loyalty, care, and full disclosure upon them. In the “fiduciary relationship” the advisor carries on dealings with the client at a level far above ordinary, or even “high,” commercial standards of conduct.

The fiduciary relationship is characterized by the fact that the specific conduct of the fiduciary cannot be circumscribed by the client in advance. Hence – to avoid self-dealing – the fiduciary duty of loyalty is imposed by law in order to compel the fiduciary to act in the best interests of the client, rather than in the fiduciary’s self-interest. In the securities law context, fiduciaries are prohibited (within the bounds of their own reasonable compensation, and with certain exceptions) to misappropriate the economic value which can be obtained for the client from their investment management or advisory services for their own benefit.

**Why Are Fiduciary Duties Imposed By Law?** The imposition of fiduciary obligation facilitates the efficient allocation of resources by protecting the beneficiary of the fiduciary relationship from overreaching by the provider of services. Typically, that provider is a professional who specializes in the provision of that service. The specialization of function forces individuals to rely on others to produce goods and services on fair terms. That reliance has necessarily afforded the opportunity for specialists to act in a self-interested fashion at the expense of the client by using their superior knowledge or skills. Accordingly, the fiduciary standard is applied to minimize the transaction costs of regulating specialized exchanges.

To promote the efficiency gains of specialization, society imposes special regulations on occupational groups having the greatest latitude to drive hard bargains, such as those in confidential relationships with clients. The activities of the fiduciary are, therefore, policed by imposing certain duties upon the specialist-fiduciary; these duties are imposed to avoid the inefficiencies resulting from specialist overreaching. Accordingly, the fiduciary’s duty of loyalty requires the fiduciary to follow the course of conduct the beneficiary would have chosen if the beneficiary had either the same expertise as the fiduciary or had consulted another fiduciary.

In essence, fiduciary duties are imposed by law when public policy encourages specialization in particular services, such as investment advisor services or legal services, in recognition of the value such services provide to our society.

## **Let’s Take Apart ‘Investment Advice’**

Should “investment advice” be provided as a commercial, arms-length transaction, or within the parameters of a fiduciary-client relationship?

Federal securities laws and regulations protect investors largely through requiring the disclosure of information – whether it be of material facts regarding an issuer of a security, or of compensation paid to a financial services intermediaries, or of conflicts of interest which exist as to financial services intermediaries.

However, disclosure does not address investors’ difficulties in dealing with the psychological issues of risk aversion, overconfidence, and cognitive dissonance. Moreover, many investors do not enjoy the intended protections of securities laws because disclosures are either inadequate (as to the quality or quantity of information provided), incomprehensible to the individual consumer (in terms of the language or terminology utilized), or deficient in timing (i.e., coming only after the consumer makes a decision).

While efforts have been made to formulate disclosures in “plain English,” this may have exacerbated a related problem – one in which individual investors receive a large volume of disclosure documents to the point of being overwhelmed. (Who among your clients actually reads prospectuses, statements of additional information, and semi-annual reports of funds?)

Furthermore, to accept the premise that investors are responsible for understanding what they read and then will act prudently thereafter, it is necessary to conclude that investors are not only armed with timely and adequate disclosure, but also that they possess an ability to understand the disclosures which have been provided to them, both intellectually and unhampered by behavioral biases. However, consumer ability to understand is difficult due to the enormous knowledge base required to undertake decisions in dealing with today's highly complex financial world. Also, due to bounds upon human behavior, the extent to which people actually and effectively pursue utility maximization is limited. Recent advances in understanding individuals' behavioral biases has revealed the substantial barriers to the individual investors possess in reviewing and understanding disclosures, and to provide informed consent even after full disclosure.

## **Weaknesses in human cognition**

Moreover, not only can financial consultants who are familiar with behavioral research manipulate consumers by taking advantage of weaknesses in human cognition, but competitive pressures almost guarantee that they will do so. As evidence of the foregoing, many financial advisors (including this author) have been trained by consultants to first establish a relationship with a prospective client based upon trust and confidence, long before any discussion of fees or products; such training is commonplace in the securities industry. As many successful advisers realize, once such a relationship is accomplished, the "sale" of either the product or the service is easily accomplished.

The ineffectiveness of disclosures is revealed when viewing the fees derived by financial industry intermediation. While various studies have been undertaken to discern the total costs of intermediation (i.e., all of the costs surrendered by consumers to financial services intermediaries), the data in such studies is usually incomplete. Nevertheless, it would be reasonable to conclude that 25% to 40% of the total returns offered by the capital markets to individual investors are consumed by financial services intermediaries. No one disputes that financial advisors, possessing great skill, deserve reasonable compensation. However, the fact is that a huge amount of the returns of the capital markets do not reach individual consumers, and that consumers are usually unaware of much of this interception and diversion.

The way to cure this problem is not only through better disclosures, but also through embracing the notion of purchaser's representatives (fiduciaries), who possess the duty to keep total fees and costs reasonable for their clients. Financial advisors, armed with knowledge of the "hidden fees and costs" found in many investment products, and bound by a duty to act in the best interests of the client (and not as the representative of the product manufacturer), can and will apply economic pressure on product providers to lower fees and costs.

In conclusion, the fact is that we should no more expect the vast majority of individual consumers to be able to successfully navigate today's complex financial world than we would expect them to act as their own attorney or physician. Merely providing enhanced disclosures is insufficient to ensure investor protection. Accordingly, investment advice properly is provided in the context of the fiduciary relationship. Our fellow Americans need, and deserve, the investment advisory services of a true professional.

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## Attributes of a True Profession

What is a “true professional”? I submit that the following qualifications must be met. By these measures, investment advisors are only part-way down the path toward a true profession.

**1. Professional Independence.** The training and the work based on a body of knowledge is controlled and organized by one or more professional regulatory organization(s) which, through appropriate legislation, are relatively independent of the state (i.e., political influence over standards of conduct) and commercial interests (in which standards of conduct might be lowered due to the economic self-interest of corporations). No professional regulatory organization currently exists which meets these criteria.

**2. Body of Knowledge; Expertise.** A profession recognizes a discrete body of knowledge and skills. This body of knowledge is important to preserve, regulate, propagate and develop for the common good of society. Acquisition of this body of knowledge requires a long period of education and training. The profession controls the content of the required training and requirements for its completion. The profession also adopts appropriate continuing education standards. Neither the Series 7 nor 65 exams establish a high bar for entry into a profession. While many financial planners and investment advisers voluntarily subscribe to knowledge, education, and experience requirements, such are not generally mandated by specific securities regulations.

**3. Professional Regulation, Ethics, and Character.** The profession is governed by its own code of ethics (i.e., mandatory rules of professional conduct) in addition to the normal laws of the land. The profession is responsible for the technical and ethical criteria by which their members are evaluated and regulated. The profession has the right and duty to discipline unprofessional conduct. The profession limits the practice of this knowledge to men and women of good standing only. Unscrupulous persons practicing these skills can lead to significant harm to the profession itself.

History has shown that when individuals are involved in the oversight of their own profession, professional standards are maintained and enhanced over time. Why? In part the reason is economic. The greater the prestige of the profession, the greater the utilization of the profession’s services by consumers. In another respect, individuals desire to be accorded recognition for their attainments, and possessing membership in a profession which possesses broad public support and respect is personally attractive.

In contrast, when commercial interests (i.e., securities firms, or an organization consisting of same as members) govern the establishment of standards, the profit motivation is deemed paramount, and high standards of conduct are diminished over time.

**4. Legal Aspects; Exclusivity.** Through appropriate legislation, the profession possesses exclusive rights to practice, regulate and propagate in this area of knowledge. The mandates of the professional regulatory organization are formalized by enabling legislation and the adoption of an appropriate set of bylaws for the organization. (Currently, no legislation provide oversight of individual professionals by a professional regulatory organization.) The profession’s control of the right to practice the profession must, however, be subject to some form of government oversight, lest the requirements for admission to the profession and/or its application of rules become unreasonably restrictive.

**5. Public Purpose.** The profession is expected by the society to provide leadership, address problems and offer solutions in this area of expertise for the common good of society. Because of the grant of an exclusive right to practice within a prescribed body of knowledge, the society expects professionals will provide service to the public within the area of their expertise.

**6. Reasonable Fees, Fully Disclosed.** The professional is entitled to professional fees in the delivery of the service. No particular form of fee payment is mandated, provided that: (1) all fees and material compensation are fully disclosed; and (2) the fees should be commensurate to the level of service (dictated in part by the high standard of conduct adopted for the professional practice) and/or complexity of the work involved. Recognition of superior performance flows from peers through internal programs promoting professionalism, innovation, and the sharing of expertise; little attention is given by the profession itself to the attainment of profitability. Rather, it is assumed that professionals are compensated fairly and in accord with the high degree of expertise required. Will investment advisers and/or financial planners proceed down the road toward a true profession?

## **History repeats itself**

I am often struck by the parallels of 1940 and 2010.

Congress enacted the Advisers Act seven decades ago to protect consumers and honest investment advisers, to establish fiduciary standards and require full disclosure of all conflicts of interests of “investment advisers,” broadly defined. Yet, one might reasonably ask why “honest investment advisers” had to be protected by the Advisers Act. Was it not enough to just protect consumers?

The answer can be found in economic principles, as set forth in the classic thesis for which George Akerloff won a Nobel Prize: “There are many markets in which buyers use some market statistic to judge the quality of prospective purchases. In this case there is incentive for sellers to market poor quality merchandise, since the returns for good quality accrue mainly to the entire group whose statistic is affected rather than to the individual seller. As a result there tends to be a reduction in the average quality of goods and also in the size of the market.” George A. Akerloff, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, *The Quarterly Journal of Economics*, Vol. 84, No. 3. (Aug., 1970), p.488.

In essence, George Akerloff demonstrated “how in situations of asymmetric information (where the seller has information about product quality unavailable to the buyer), ‘dishonest dealings tend to drive honest dealings out of the market.’ Beyond the unfairness of the dishonesty that can occur, this process results in less overall dealing and less efficient market transactions.” (Frank B. Cross and Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 *Cardoza L.Rev.* 334, 366 (2006)). As George Akerloff further explained: “[T]he presence of people who wish to pawn bad wares as good wares tends to drive out the legitimate business. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence.” Akerloff at p. 495.

## **Asymmetric information**

The bona fide fiduciary standard of conduct is society's response to asymmetric information. It requires the fiduciary to adopt the means of the client as his or her own. It requires the investment adviser to become, and at all times act, as a professional.

If investment advice ever becomes a true profession, in which a bona fide fiduciary standard of conduct exists, and objective advice must be provided at all times, then the demand for personal investment advice and financial planning advice will soar. Until that time, distrust of "financial advisors" will continue, as so many continue to sell "lemons." Until the provision of investment advice constitutes a true profession, we'll continue to see articles in the press about how "MOST" "financial consultants" (both registered representatives and investment advisers are often grouped into this category) don't "add value." The press will continue to opine, "Since "financial advisors" have so many conflicts of interest – why bother hiring one? Why not just 'do it yourself'?"

In today's modern complex world, the fiduciary standard of conduct is now more important than ever to our fellow American citizens. Yet over seven decades ago the essential need for the fiduciary standard for securities professionals was well known. In 1934, Justice Harlan Stone explained the need for fiduciary capitalism, stating: "I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.'" Here we are, following another financial crisis of near-epic proportions caused in large part by commercial interests whose conduct was not guided by true professionals. How many "Great Recessions" or "Great Depressions" must America endure before a true profession for investment advisers is embraced?

## **Roosevelt's vision**

In 1932, Franklin D. Roosevelt expressed his vision that the enactment of federal securities laws should "restore the old idea that a person who uses other people's money is doing so in a fiduciary capacity." Of course, the passage of Roosevelt's vision was only partly successful, for the "members of the pertinent committees in the Senate and House were barraged with opinions, advice, promises and threats from lobbyists and principals of the securities industry." Déjà vu?

Seven decades later our policymakers again face the impetus for financial services regulatory reform. The correct path to take is to create a professional regulatory organization, in which individuals (not firms) establish and maintain professional rules of conduct for investment advisers and/or financial planners profession. Only then will the individual professionals, armed with a correct understanding of the importance of fiduciary standards to both consumers and to the professionals themselves, enabled with personal resolve and courage, foster the emergence of a bona fide profession for investment advisers. Only then will consumers view investment advisers as professionals. Only then will our fellow citizens receive at all times the objective advice of the fiduciary investment adviser they so desperately need.

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## Part Two: The last advice model standing

### Five links on the evolutionary chain toward a profession

by Ron Rhoades, Guest Columnist

Washington's attention to financial advice is a major step in its evolution.

*Elizabeth's note: In this accompanying piece to his column about the evolution of investment advice as a profession, Ron Rhoades give us this brief history of the intellectual shift between the brokerage model and the RIA model. This article is an addendum to his article about whether financial advisors are a true profession.*

Discussion of an investment advisory profession must be understood in the context of the decline of the brokerage model and the increasing importance of financial security in the eyes of policy makers. Here are five changes that the modern era has brought to investment management. Those changes may lay the groundwork for a true investment advisory profession.

**Fixed Commissions Are Eliminated.** First, there were dramatic changes to broker-dealer firm revenues. From 1792, when the New York Stock Exchange fixed commission rates for brokerage transactions under the buttonwood tree in the Wall Street area, until 1975, broker-dealer firms relied upon commissions for a large part of their revenues. It was only after a private litigant alleged a violation of anti-trust laws in the mid-1960's that this practice was deemed untenable. Extensive SEC hearings commencing in 1968, as well as Congressional hearings in 1971, along with pressure from the U.S. Department of Justice and several pending judicial appeals, led to the SEC's eventual 1974 decision to abolish fixed commissions, despite extensive lobbying by the Securities Industry Association (now SIFMA) and the New York Stock Exchange (as to its regulatory aspects, now FINRA).

**Market Making and Price Fixing Scandals Cast Doubt on Regulators.** Second, the era of computerization of trading systems has led to the substantial demise of the role of market makers – another huge source of revenue for broker-dealer firms (either directly through market making operations, or through ownership of market making firms). Another scandal on brokerage compensation practices rocked both broker-dealer firms and the NASD (now in part FINRA) in the mid-1990's. In connection with this scandal, Arthur Levitt, then chairman of the SEC, called NASD “the cop on the beat” that “simply looked the other way.” Levitt said that the evidence showed NASD “did not fulfill its most basic responsibilities” and concluded that by NASD's failure “American investors were hurt — large and small, sophisticated and inexperienced, institutional and individual — all were hurt by these practices.” (Statement By SEC Chairman Arthur Levitt, Press Conference Regarding The NASD, Washington, DC, August 8, 1996.) Richard Ketchum, then NASD's COO (and now Chairman and CEO of FINRA), told the Los Angeles Times in May 1994 that the Christie and Schultz report – which raised the question of collusion among NASD-member firms in their price-fixing activities – was “irresponsible – and in fact we believe it is slanderous.” In a 1994 interview to PBS, Richard Ketchum defended NASDAQ price quotations in eighths, rather than in sixteenths, out of concern for “liquidity.” As seen by the move to decimal pricing during the last decade, Mr. Ketchum's concerns were unfounded and, with respect to the brokers regulated by FINRA, self-serving.

**Traditional Brokerage Services Become a Commodity.** Third, and as noted in a recent white paper by Professor Arthur Laby, the execution function of brokers has become much easier. “Changes in securities trading brought about by changes in technology have rendered brokerage a commodity, which no longer entails the level of judgment and skill required to conduct brokerage services in the bygone era of the early twentieth century.” In essence, brokerage execution services, like the other services provided by brokers (custody, arranging for the delivery of certificates – a practice which has largely been eroded, and record-keeping – a practice made more difficult with the pendency of cost basis requirements but easier with the aid of technology), have become commodities.

**Investment and Financial Planning Advice Becomes Essential.** Fourth, the provision of investment advice, especially of an ongoing nature, has risen in prominence. The financial world for individual Americans is far more complicated today than it was in 1940. Gone for the most part from private industry is the promise of a monthly pension check in the mailbox, replaced with defined contribution accounts and individual responsibility to save and invest for one’s own financial future.

Moreover, there exist a broader variety of investment products, including many types pooled and/or hybrid products, employing a broad range of strategies. This explosion of products has hampered the ability of individual investors to sort through the many thousands of investment products to find those very few which best fit within the investor’s portfolios. Furthermore, as such investment vehicles have proliferated, individual investors are challenged to discern an investment product’s true “total fees and costs,” investment characteristics, tax consequences, and risks. Additionally, U.S. tax laws have increasingly become more complex, presenting both opportunities for the wise through proper planning, but also traps for the unwary.

As the sophistication of our capital markets had increased, so has the knowledge gap between individual consumers and financial advisors. Investment theory continues to evolve, with new insights gained from academic research each year. In constructing an investment portfolio today a financial advisor must take into account not only the individual investor’s risk tolerance and investment time horizon, but also the investor’s tax situation (present and future) and risks to which the investor is exposed in other aspects of his or her life.

**Washington Has Started Paying Attention.** Fifth, the importance of investment and financial planning advice, from a public policy standpoint, has not gone unnoticed in the halls of Washington, D.C. and in the capitals of the many states. Proper financial planning is essential to encourage both an increase in household savings and in order to invest those funds more effectively. If people do not make careful, rational decisions about how to provide for their financial security over the course of their lifetimes, then the government will have to step in to save people from the consequences of their poor planning.

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