October 14, 2016

Dear Friends and Clients,

As of April 6, 2016, the Department of Labor (DOL) has expanded their "Investment Advice Fiduciary" definition, which was originally defined under the Employee Retirement Income Security Act of 1974 (ERISA). This rule makes a fiduciary of every broker, banker, insurance agent, accountant and investment advisor receiving compensation for providing investment advice in retirement accounts (IRAs, 401ks, 403bs, etc.). Prior to the expansion of this rule, the above were allowed to offer advice to retirement accounts in compliance with the suitability standard, which is a much lower threshold of care. As you can see, it has been 42 years since the DOL originally promulgated this rule.

These changes in suitability are not easy to explain without retracing history a bit. The investment industry has multiple regulators and diverse business plans addressing an assortment of client types. If this letter seems critical of any of those groups so be it….one size does not fit all. Please accept our remarks as constructive criticism….the breakfast of champions. Delivering our clients a financial advocate in a transparent business plan free of conflicts of interest has always been the goal of P&A. We have always found comfort in the fiduciary standard which puts our client's interests above our own. The popularity of these concepts do not hold industrywide and reform seems to move erratically, so in many ways our industry will always be caveat emptor…buyer beware. To that end, P&A strongly believes in client education. It's our opinion that the risks assumed by using inappropriate business plans and a lack of regulator understanding are far greater than those that accrue from price volatility.

This letter will build toward an explanation of a recent event, the DOL's final rule on the fiduciary standard as applied to retirement accounts, and why it is important to you. Feel free to check out www.surtherland.com/portalresource/DOLFinalRulev2.pdf for a 26 page third party opinion on the subject. We also hope you will work your way through this letter and then feel free to ask as many questions as you like. Hopefully it will entertain as well as inform. The Sutherland letter linked above is an industry white paper; our letter is life as we see it.

The Back Story……Stockbrokers and the Traditional Transactional Business Model

This is the business model I was hired into almost 47 years ago, it favors the sale of investment securities and is regulated by the Securities Exchange Act of 1933 (the Exchange Act). Brokers are the guys you always invite to a party; they're youthful, like to put lampshades on their heads, tell jokes and get everyone involved. Point of sale success in the financial industry is highly dependent upon a vibrant personality and one's ability to communicate…. boring personalities just don't survive. Long term success, on the other hand, requires intellect, consistency, ethics and integrity. So somewhere along the line these qualities have to meld.

After college, my first coat and tie salaried job was at a bank. The running mates I had there were straight shooters, honest and very banker-esque. We sold government bonds, municipal bonds, CDs and federal agency securities…big dollar trades were common but pretty bland stuff. All of our revenues were transactional, just like a stockbroker. It was a good spot for a 22 year old; I found a way to fit in and had a gas. We were a division of the bank and as a result regulated by the Comptroller of the Currency. They were used to supervising loan officers and didn't have a lot of depth when it came to figuring out a securities operation.

My second job was at a brokerage firm, this was an edgier crowd to say the least. No salary, straight commission, beaucoup financial products and a rogues' gallery of salespeople. In accordance with the Exchange Act, our compensation was transactional and all the advice we offered was "incidental," we received no "special" compensation related to the giving of advice. Keep track of these differences in compensation, they will play a big part in this story. Also consistent with the Exchange Act, all of our trades were solicited and we were held to the suitability standard of care (more to come.)

When I started at Dean Witter in 1976 we were referred to as a "wire house." This term evolved from the AT&T communication system that connected the branch offices to the regional offices, the home office and ultimately to all the exchanges and market makers. It was actually a very efficient, high tech, low cost business plan and shared by names like Smith Barney, EF Hutton, Shearson Lehman and Paine Webber (may they all rest in peace). Brokerage firms of that day were huge sales organizations and regulated by the NYSE, NASD, SEC, CFTC, CBOE, MSRB, DOL and 50 state insurance departments. Onsite regulation was pretty simple, every brokerage office had a branch office manager (BOM) who is required to hold (or delegate) a principal designation issued by each of the regulators with oversight. Brokers were called Account Executives (AEs) or Registered Reps (RRs). They were and still are the primary policemen for their own behavior (you'll run into self-regulation again in this letter). The BOMs represented the next line of regulation (think defense if you were a customer) and got slapped with failure to supervise when the AEs or RRs misbehaved. Brokerage houses were and still are racked with turnover and it was difficult for one BOM to acquire and maintain all those designations. So if you work for a brokerage house long enough and keep your nose clean enough, you were almost certain to be asked by management to test and fill in one or all of the BOM roles. This was considered a promotion by the outside world, included a title change, and paid little to nothing extra. You guessed it, I was a principal in the eyes of all these regulators.

Mahogany Desks and Private Offices….

The trust officers at the bank I worked for in 1970 all had their own secretaries and private offices. They didn't consider brokers their competitors, thrived on referrals from attorneys, managed accounts with discretion and were held to a fiduciary standard. Most of their trusts owned commercial real estate, farms and closely held businesses…in addition to marketable securities. Portfolio transactions were done by committee and clients were often asked to sign off on trades even though the department had discretion. Experience taught me that the trust officer's first responsibility was to keep the bank from getting sued. To that end, most of the trust administrators were attorneys. Their second task was to preserve principal which meant hold a lot of cash. Third came performance, fourth communication and somewhere further down the line develop new business. Most trust officers spent 40% of their time in litigation avoidance, another 40% preserving capital and the remaining 20% managing portfolios and developing new business. These guys were regulated by the Comptroller of the Currency if they were part of a bank or the SEC if they were independent.

The Registered Investment Advisor (RIA) was created by the Investment Advisors Act of 1940 and of course regulated by the SEC. We will call the first generation of Investment Advisors IAs and the second RIAs. IAs managed with discretion and behaved much like trust officers, achieving only a modicum of popularity until the early '90s. The IA business plan employed high priced independent custodians, paid their bills with soft dollars generated by high commissions, used expensive business plans and behaved like wealth managers or family offices. They too did not consider brokers their competitors. Both the Trust and IA business plans depended on telephones, yellow legal pads, face to face meetings and hand posted ledger sheets. Both were compensated by management fee only which reduced conflicts of interest and appealed to high net worth investors. These two business plans proved to be extremely vulnerable to the advent of RIAs, traditional brokers and improvements in technology.

The Suitability Standard….

Having worked in one, I have always likened a brokerage office to a box of puppies; some sleeping, several chewing on each other, a few wrestling and all of them relieving themselves at will. Each box had its own regulators, momma dog and daddy dog, a set of rules and family standards. Mommy and daddy don't mind a little chewing but they don't want to see any bloodletting. Likewise, the Exchange Act of 1934 (regulated by the NYSE and NASD) laid down the rules for stockbrokers, expecting them to solicit orders and be commission compensated. Unfortunately, some brokers had been charging a separate fee for advice since the mid '20s. This scenario continued until the advent of the Advisors Act in 1940, which held Registered Investment Advisors (RIAs) to a fiduciary standard. Brokers were asked to adopt this standard of care, and said "we don't want to." At this point (read good lobbyists), Congress became sympathetic toward the rapscallions and decided they could offer incidental advice as long as they did not receive "special compensation" for it. Instead of the fiduciary standard, they would be held to the suitability standard, which required brokers to reasonably believe that any recommendation made to a client was suitable in terms of financial need, objectives and unique circumstances. This allowed them to recommend mediocre in-house products over those of lower priced, higher performing third party vendors. Suitability describes a customer/vendor relationship, not a contractual agreement. Broker obligations and customer expectations are defined by the account forms written by the broker and signed by the customer when an account is opened. The NYSE and NASD self-regulated the Securities and Exchange Acts until they were replaced by the Financial Industry Regulatory Authority (FINRA) in July of 2007.

The Fiduciary Standard….

Registered Investment Advisors (IAs and RIAs, both of which we will refer to as RIAs going forward) are paid to offer advice to their clients. They are registered with and regulated by the SEC or a state's securities agency (but not FINRA.) This group includes portfolio managers, financial planners, research boutiques and some newsletters. Under the Advisors Act, RIAs must conform to the fiduciary standard. This requires an RIA to always serve in their client's best interests with an intent to eliminate all potential conflicts of interest. Most RIAs charge an asset based fee and compensate their Investment Advisor Representatives (IARs) with a salary and incentives based on client performance. Since client interests are placed above those of the firm and the adviser, the fiduciary standard is considered a higher level of care than suitability. It is the same standard that trust officers are held to.

On July 10, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by Barack Obama. Section 913 of the act specified the need for uniformity in the standards of care imposed upon brokers, dealers and investment advisors. To that end a study was released by the staff of the SEC in January 2011, which recommended a fiduciary standard for both brokers and RIAs when providing advice to retail clients. That standard was to be no more stringent than the current fiduciary standard that RIAs are held to, i.e. act in the best interest of the client without regard to the financial or other interests of the broker-dealer or investment advisor providing advice. The SEC has yet to respond to its own staff's recommendation.

The Ingredients for a Fire….

1) **FUEL:** On Labor Day 1974, the Employee Retirement Income Security Act (ERISA) was signed into law by Gerald Ford. Its primary purpose was pension reform on the heels of a retirement plan debacle at Studebaker Corp. Along with it came the IRA account, a low profile savings tool that allowed individual investors to defer up to $2,000 of earned income annually and in doing so avoid paying that tax burden until their retirement years. ERISA become the responsibility of the Department of Labor (DOL). In addition to its deferral powers, the IRA became an extremely powerful financial tool when used as the inheriting account when the lump sum proceeds of 401ks, 403bs or other IRAs were "rolled over." Stockbrokers used this tool to steal more business than the banks, trust departments and wealth advisors knew they had.

2) **OXYGEN:** In 1979, I bought my first Apple computer. After learning how to use it I was able to improve my workload capacity by a factor of 10….maybe 20. Most of my trust department and wealth advisor buddies scoffed at these "toys," apparently they weren't looking for ways to work harder. Accuracy improved, sophistication expanded and creativity new no limit. Dean Witter installed workstations on all of our desks in the mid '80s and in doing so moved their wire from the cage to each AEs desk. This was akin to issuing repeating rifles to the 7th Cavalry. A plethora of large high net worth clients, foundations and retirement plans now came within range. The first dial-up internet connection was offered to the public by Sprint in July of 1992. Much to my chagrin, I was scooped on that event by my sister and her two teenage sons. The boys showed their mom how to fetch recipes and needlepoint with this new gadget and she couldn't wait to show it to me. I was humiliated and soon became connected. After researching Canadian fishing lodges, new golf courses and football point spreads, I started creating P&A.

3) **HEAT:** In the early '90s, I met with a customer who had recently sold his company. His son (a ne'er do well) entered the room and greeted me. I asked him how his entry level bank job was going and he told me he quit. Said it was boring and he didn't like it. I asked what he was going to do next and he told me without so much as a twitch, "I'm an investment advisor." "Sounds good," said I… "best of luck." At that time I had 24 years in the business, a CFP ® designation, and an associate degree from Wharton. Less than a week after he was hired, this pup had the same title I did. About this same time the brokerage industry started to perfect the "wrap fee" account. Using a separate account they would hire an outside manager with a proven record to manage client assets. This product originated with stocks and bonds but quickly morphed into mutual funds, commodities and options disciplines. It was one step too far for our transactional friends, the SEC considered it special compensation for offering advice.

Slow Ignition….

We can find no evidence of a standard of care being imposed on stockbrokers by either the Securities Act of 1933 or the Exchange Act of 1934. All of these acts have been amended by Congress, case law and convention. Any of those could be the origin of the suitability standard. The curious part of this is that brokers are easily the most aggressive animal in the jungle we call Wall Street (we know….we were one), and in addition to controlling the actions of their registrants, the regulators are supposed to protect the public. We <u>can</u> find evidence of a fiduciary standard coming into existence with the Advisors Act of 1940. It's our suspicion that the fiduciary standard actually created the lower suitability standard. The brokers argued that it would be onerous to enforce a higher standard of regulation upon them when the advice they gave was only "incidental" to their business. Stated from an RIA's point of view, they argued against placing their client's

interests above their own unless there was “significant” compensation involved. So in 1941, Congress bought into this line of logic and granted the brokers an exemption to the fiduciary standard as long as the advice they offered was incidental to their business plan. Not surprisingly, there is no definition for the term “incidental” in any of the acts, nor in the exemption. This was a prelude to dual registration and Congress had no problem buying the Kool Aid, the brokers’ lobbyists won again and the exemption stood for over 60 years.

The chickens lived with a fox in the hen house until the mid ‘90s when the friction around these relationships started to smolder. From our point of view the conflict between fiduciary and suitability always centered around the integrity, or lack thereof, delivered to a relationship when the “advisor” was paid by the product being sold. This of course focuses on the transactional types. We felt then, and still do, that it would be impossible to deliver unbiased advice in a business plan like this. Likewise, we felt it disingenuous and deceiving to call yourself an advisor if your pay was transactional. It appeared the SEC was starting to draw a similar line in the sand during the early ‘90s as brokers started showing a strong affection for wrap fee accounts. In the eyes of the SEC, the wrap fee qualified as “special compensation” and was earned by delivering advice, certainly cause for registration as an advisor. Registration, in turn, held brokers to a fiduciary standard of care. The rapscallions wanted no part of that because it precluded the sale of high priced, low performing in-house products.

Perhaps even more threatening was the fact that their business plan was ill equipped to manage brokers to a suitability standard, let alone a fiduciary one. The transactional types could see nothing but lawsuits on the horizon. Unlike the term incidental, special compensation was defined by the Advisors Act. We were still stuck on integrity and the whole affair reminded us of arresting Al Capone for tax evasion…but we were out the door anyway. Mid 1995 saw the birth of P&A, consistent with the proliferation of a new, modern style of RIA. We used a discount broker (Charles Schwab) as our custodian, employed the internet as often as possible, slashed fees and lived on the third floor of a suburban office building. Our brokerage skin was officially shed. We felt a new fiduciary standard was right around the corner and it described the way we wanted to behave.

The joke was on us. Instead of being forced to respond to a higher standard of care, the transactional types slipped the punch again…and actually proliferated. In 1995, the SEC directed the Tully commission (named after chairman Dan Tully) to generate a report on compensation practices. It took them four years to do it but for some reason these guys came to the conclusion and were able to convince the SEC that having brokers receive some compensation from fee-based accounts seemed like a good idea…it would better align the interests of the firm and the broker. So there you have it, more chickens for the foxes. Dan Tully was the seated Chairman of Merrill Lynch at the time and Warren Buffett served as a committee member. In 1999, the SEC issued a no-action letter promising not to enforce cases against unregistered brokers using wrap fee accounts while offering advice “incidental” to their business.

The Fire Was Starting to Burn ….

Everyone but the SEC called the exemption the “Merrill Lynch rule”…I wonder why? It probably would have held sway longer than it did, but there were a few new sheriffs in town. Sheriff #1 - The early ‘90s saw the birth of a new and different RIA. These people were Boomers, used discount brokers as custodians, the internet for research, PCs to support portfolio management and had roots in financial planning. Their business plan was fee only and they grew like a hutch of rabbits (once again, we are one). Sheriff #2 - The Financial Planning Association (FPA) was an aggressive advocate of the new RIAs and led the charge against the Merrill Lynch Rule. Sheriff #3 – Retail investors themselves. This was and continues to be a very educated group of people. Pro-active Boomers seem to account for the largest share of this group and the Gen Xers and Ys fear no one. All expect their advisors to be void of conflicts, web savvy easy to communicate with.

The “Rule” granted brokers the privilege of delivering a suitability standard of care while offering advice deemed incidental and being paid commissions, wrap fees and mutual fund trails. This left the door open for recommending in-house products as well as high priced third party investments. In exchange, it became the broker’s obligation to inform the customer of any change in their role at all times….self-regulation at its finest. Picture someone you pay both fees and commissions to sitting across the desk, changing hats while saying “I’m a salesman…I’m an advisor…I’m a salesman…I’m an advisor…” Naturally, as RIAs we were suspicious of the number of brokers actually making these distinctions. The FPA was not going to have it and flames started to leap from the fire.

The SEC fended off the Financial Planning Association until July 2004. According to Duane Thompson, the FPA’s top lobbyist, “The SEC wasn’t being responsive.” Exasperated, the FPA sued. This caught the regulator off guard and the SEC re-purposed the Merrill Lynch rule in January of 2005, approving it in April. There wasn’t much change and the FPA was incensed…..consider this a three-alarm fire. They took their case to the U.S. District Court of Appeals…and in 2007, they won! The SEC did not appeal and brokerage firms were forced to convert over $300 billion in fee-based brokerage accounts to advisory platforms delivering the fiduciary standard of care. The term “incidental” now had a dollar sign next to it.

Although hanging on to those funds brought a smug smile to a lot of transactional faces, an age old problem still remained unsolved…..greed. Conceptually, stockbrokers believe they should be able to have their cake and eat it too…..trade stocks, offer advice and enjoy the consistency of fee income. Why not, the regulators allowed them to do that for 67 years! However, if ever enforced, the regulatory burden imposed by the Appeals Court decision would become onerous and the brokers knew there would be plenty of piling on. As the brokerage firms surveyed their boxes of puppies they now knew it was necessary to train and regulate them. Into every life a little rain must fall.

So Here We Are in 2016….

This time it was nine years between seminal events. As we started the year there were about four or five warring factions in this food fight…brokers, RIAs, the trade groups and the regulators. *Investment News* has had a good time fanning the fire as well. Let’s face it, pretty much everyone was against the brokers and their lobbyists. Then in April comes the Department of Labor (DOL) issuing its final rule on the fiduciary standard as applied to ERISA accounts. You remember the DOL, they’re the guys that ERISA charged with the responsibility of regulating IRAs, 401ks, 403bs and the like. The guts of this fiduciary ruling significantly expands the circumstances in which broker-dealers, investment advisers, insurance agents, plan consultants and other intermediaries are treated as fiduciaries for ERISA plans and IRAs. In turn, precluding them from receiving compensation that varies when different investment choices are made. It also prohibits them from recommending proprietary products absent an “exemption.”

The Best Interest Contract (BIC) Exemption requires advisers to acknowledge their fiduciary duty and lays down a set of procedures that, if followed, allow the adviser to receive variable or commission-based compensation even when that compensation creates an otherwise impermissible conflict of interest. This “exemption” is a formal document signed by the investor and the adviser. There are four BIC Exemption categories. The first two allow the broker to receive variable or commission-based compensation. The third allows the adviser to roll retirement assets from accumulation plans to consolidation and distribution models. The fourth is a transition exemption which will allow advisors some calendar latitude in complying with the new law.

It is safe to say that the traditional brokers are not fond of the DOL ruling. With any kind of luck, the imposition of a fiduciary standard and the threat of litigation outside FINRA's normal dispute resolution process will persuade abusive brokers to drop from the ranks of those that peruse retirement plan rollovers. We have already witnessed some of this capitulation and expect to see more of it. P&A has long held the opinion that the modern brokerage business model cannot operate profitably given a client that invests only in common stocks and investment grade bonds. IRAs and IRA rollovers have long been the source of broker capital to fund illiquid high spread packaged products. Without the revenue generated by these investments the business plan just does not work. The DOL's ruling will put an end to some of this activity and for that we are glad. We compliment the regulator for taking the actions they have and eagerly anticipate revisions that will be easier for professionals as well as the public to understand.

So Who's on First?

That's what we'd like to know. I have been writing these quarterly letters for over 21 years now and most of the time the words flow like a river. This letter was easily the most difficult I have ever written. The labyrinth of regulators, acts, and statutes that the financial services industry is subject to is mind boggling. It would be different if the individual investor felt protected, but the majority do not. Instead, and understandably so, they feel confused. We are pleased that the DOL took a stab at resolving this problem. If in fact they have been successful, we are less than half done with the project. Their ruling applies only to ERISA (retirement) accounts. Your after tax accounts are still subject to the vagaries and hustle delivered by the army of transactional brokers hovering overhead. Mary Jo White, the seated chairman of the SEC tells us that her agency is working on a uniform fiduciary standard. We would be more excited about seeing results if two of the five commissioner chairs were not vacant. Apparently they have been held up in Senate confirmation for the last 18 months.

The World According to Dan and Pitt…

Although the markets seem to be flat, as of 9/30/16 the Dow and S&P are up 7.04% and 7.72% year to date. This makes high single digit returns well within the realm of possibility. With the 10 year Treasury yielding 1.79% and the 5 year weighing in at 1.29%, equities look pretty attractive to me. The "real" return of any investment is its gross return minus inflation. The historic real return for equities from 1950 – 2015 is 7.00%. That means our current inflation rate of 2.00% would predict a gross equity return of 9.00%. Hang in there baby, we still "Really Like" equities.

As Always,

James S. Pittenger, Jr,
Chairman/CEO
CFP®

Dan Anderson
President
CFP®