What Type of Financial Advisor Advises You?

For individual investors seeking advice, the world they enter can be a confusing place. I'm thinking here of the different types of financial advisors that offer to help investors deploy their capital. Non-finance people shouldn't need to bother themselves with subtle elements of the investing regulatory landscape, but there are some things they're better off knowing. Financial advisors don't all operate with the same set of objectives. Some, who work for investment advisory firms and are Registered Investment Advisors (RIAs) are bound by the 1940 Investment Advisors Act to conduct themselves as a fiduciary, meaning they're legally obliged to put their clients' interests first. It seems like a sensible standard, but it's not the only standard. There's another class of financial advisor who work for broker-dealers rather than investment advisory firms. Their activities are bound by a lower standard of suitability and disclosure.

A financial advisor who is an RIA and works for an investment advisory firm has to put the client's interests first. A financial advisor working for a broker-dealer may not be so constrained. It's as if the RIA is sitting next to you, the client, at the table working with you to identify and implement an appropriate investment strategy, while the broker-dealer version of a financial advisor is sitting across the table from you trying to sell you something.

Neither model on the face of it is necessarily better than the other. In our business at SL Advisors we are fiduciaries and we believe that is best for clients. But the non-fiduciary type of advisor may be more appropriate for some people. When you buy legal or medical services you're dealing with somebody who has to put your interests first. When you buy an automobile or a house, you're not. Many people wouldn't want to make those purchases through fiduciary relationship. It's well understood that in buying a car you need to do your homework and that the car salesman is obviously promoting the positive aspects of the car. There's no need to employ your own agent to negotiate with a car salesman on your behalf.

The interesting question is whether the typical investor, when buying financial advice, can recognize the difference between a financial advisor *with* a fiduciary obligation and one without. The term "financial advisor" is confusing because it sounds a lot like someone whose unequivocally on your side. You need to understand the difference, and in particular whether or not they work for an investment advisory firm (fiduciary obligation) or a broker-dealer (probably, though not always, no fiduciary obligation). So next time you're talking to your advisor, ask whether they're the fiduciary type or the car salesman type.

The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act directed the SEC to evaluate whether a uniform fiduciary standard should apply to all financial advisors, not just those employed by investment advisory firms. The SEC duly did this and concluded that it would be a good idea. The brokerage industry successfully lobbied against this. They argued that it would be adverse for certain types of clients for whom coverage would no longer be commercially attractive. But there's also little doubt that it would impede the ability of broker-dealers to market some fee-laden products such as non-traded REITs (with as much as 15% of upfront fees), many varieties of structured notes and other illiquid yet expensive products. It would create enormous challenges for municipal bond dealers whose profitability hinges on the mark-up they can add to a bond before selling it to the client. Being a fiduciary is inconsistent with profiting from any of these transactions when they're sold to clients. The car-salesman type of financial advisor is far more likely to have their client invest in a non-traded REIT than the fiduciary type of advisor, because the car-salesman receives some of the upfront fees whereas the fiduciary type does not.

So two types of financial advisor will remain for the foreseeable future. But there’s still plenty that can be done to ensure that investors are better informed about the relationships they have and the investment products they’re offered. FINRA (The Financial Industry Regulatory Authority) publishes an “Investor Alert” section of its website. Its existence is not widely known, and yet it contains a great deal of basic, sound advice for self-directed investors interested to learn more. It also includes warnings on certain products (such as non-traded REITs, structured notes and the potential mark-up on municipal bonds). You’d think that the existence of such warnings from a government regulatory agency would give pause to any financial advisor (fiduciary or otherwise) selling such instruments. Maybe many do steer clear, mindful of the problems FINRA highlights, but clearly they don’t all do so.

It would seem to me a fairly obvious thing for a certain class of Investor Alert to be provided to any client prior to making a purchase. Given all the problems with non-traded REITs, why not require that any buyer be directed to the website before buying? Smokers still buy cigarettes with their government warnings. Let people make their own decision, but at least make sure they’ve been provided relevant information. If FINRA feels it necessary to issue a warning about a certain security, that ought to be known to every potential buyer. The CFA could take the lead on this issue by advocating for such communication to investors prior to a trade involving the security subject of such a warning. It would be a logical extension of the CFA Institute’s support for a uniform fiduciary standard across all financial advisors.

Even if that fairly simple step doesn’t happen, there’s nothing to stop financial advisors from conducting their business in a way that’s consistent with such investor alerts being widely known. In fact, you'd think that any reputable financial professional or firm would feel queasy at the least in profiting from securities highlighted in this way by FINRA. The financial services industry has been the subject of withering reputational attacks, some of them justified and due to self-destructive behavior. The resulting populist outrage at Wall Street and ever greater regulatory burden are the political result. Investors deserve better, and many financial professionals don't deserve the opprobrium heaped on the industry. It's time for us to start regaining trust by behaving in ways that reflect common sense regardless of whether the law requires it. Individual financial advisors need to conduct their business with the client's interests first whether or not they have a fidiuciary obligation to do so. If advisors swore off selling products that are targets of FINRA's Investor Alert website that would be one step towards taking back the industry's reputation.