

How I Learned To Quit Worrying And Love The Industry Turmoil (A new idea for investment advisors)

“If you don’t change direction, you may end up where you are heading”

Lao Tzu

Several months ago, we published an article called “Tips and Traps for Starting a Portfolio Management Firm or Dealer Firm”. (add link). In light of the excellent response we received, we have decided to issue a follow up article, which discusses the benefits for investment advisors and other financial planning professionals, of operating their fully owned registered firm.

Incomplete Solutions

Many of the solutions currently offered to senior investment advisors who are unhappy with their category of registration, the relationship with their dealer or the future direction of their practice appear incomplete.

These include offers to buy the practice at below market value or in exchange for shares of a private company, offers to merge with other practices, inducements such as greater flexibility and/or higher payouts to join other firms, etc.

The Most Unfavourable Solution

The most unfavourable solution, in our view, is the popular practice of encouraging investment advisors to enter into referral arrangements with third party portfolio managers. Under such arrangements, clients of the investment advisor are directed to enter into a management agreement with a third party portfolio manager. The manager collects a fee and then remits a portion to the investment advisor as a referral payment.

This solution may be marketed to investment advisors as an opportunity to, enhance revenues, allow the investment advisor to offer solutions that their registration does not otherwise allow, or participate in a virtual “cash for life” lottery winning. This offering is often available at no upfront fee and in many cases the portfolio manager will helpfully complete the necessary paperwork.

Unfortunately, this solution suffers from one fatal weakness. The investment advisor is effectively handing his or her assets under administration to another firm. If at a later date the investment advisor wishes to fire the portfolio manager, he/she cannot do so without the manager’s consent.

However, technically, the portfolio manager can adjust the fee, change the offering, get rid of the client, or even choose not to renew the referral arrangement without the investment advisor's consent.

This type of arrangement may also create an obvious question in the client's mind, "If the portfolio manager is managing my money, why am I paying the advisor anything?"

Many such referral arrangements are structured to paper over this weakness. For example, the investment advisor may be invited to attend or arrange the client meetings, or otherwise give the appearance that they are actually in charge of the account. The referral fee disclosure to the client may be fudged.

Unfortunately, the Securities Commissions are opposed to such finessing. In OSC's 2010 Compliance and Registrant Regulation Branch Annual Report (http://www.osc.gov.on.ca/documents/en/Securities-Category3/sn_20101015_33-734_crr-annual-rpt.pdf see page 22), the OSC made clear its expectation that the investor understand that the portfolio manager and not the investment advisor is responsible for their account, and that the portfolio manager be actively involved in the client management aspect of the relationship. NI 31-103 sets out detailed and unambiguous disclosure requirements for referral arrangements. During their on site compliance reviews, the OSC's compliance staff will also typically zero in on such arrangements.

One answer is for the investment advisor to create his or her own portfolio management firm, and hire the third party portfolio manager as a sub-advisor. Not only will this allow them to manage the client relationship independently, but they may also be able to negotiate lower wholesale prices for portfolio management services.

Investment advisors who have already signed up under such a referral arrangement may wish to consider registering their own portfolio management firm and switching to a sub-advisor arrangement.

Portfolio Managers may also wish to proactively introduce this type of arrangement as a way to market and differentiate their portfolio management services. The Portfolio Manager also benefits from a sub-advisory type of relationship as it allows them to offload all sales compliance and administrative obligations to the investment advisor.

Why We Wrote This Article

Below, we have discussed some of the benefits for investment advisors of creating and operating under their own securities registered firm.

In our next article, we will explain why we believe a portfolio manager registration is the best platform for conducting a financial planning or other retail focused securities business. We'll also illustrate how creating an independent portfolio manager may be a viable and cost-effective solution for many senior MFDA, IIROC and general financial planning professionals.

Enhance the Value of Your Practice

An independently registered firm allows investment advisors to convert their "employment" or "agent relationship" to a "business". This enhances the value of their practice and allows them to exercise greater direction and control.

For example, consider the circumstance of an investment advisor who has not specifically contracted for the right to port clients to another dealer. If the investment advisor decides to leave the Dealer prior to

retirement, he/she will probably be able to convince their best clients (with whom they have established a close relationship) to move with them.

However, on retirement, the Dealer is now in a stronger position because there is no other firm to which clients may transfer their investments. The Dealer can simply "reassign" the accounts to another investment advisor within the firm as the Dealer now owns the client from a relationship as well as from a regulatory perspective. Hence, the business that the investment advisor may have spent years building can quickly evaporate on retirement. Many investment advisors who presently operate under an IIROC registration may have this type of problem.

Even if the investment advisor is able to port their clients to another dealer or can otherwise sell their book of business, consideration also has to be given to the value of their book. At present, "assets under administration" are typically worth between one or two times the annual trailers or commissions earned depending on the average account size, account holdings, and other considerations. Nevertheless, this is typically only a fraction of the value of an independent firm.

Other Reasons for Creating an Independently Registered Firm

There are many other benefits of owning an independent firm.

Depending on the compensation grid offered by his or her dealer and the administration charges levied, the investment advisor may also increase revenues and reduce costs through an independent firm...even if their book of business shrinks during the transfer.

When an investment advisor initially starts in the business, his or her Dealer is a source of management oversight, marketing support and training, as well as operational and compliance support. However, as the investment advisor gains experience and grows his or her book, the dealer is simply required for operations and compliance support. Often, such types of services can be contracted out at a lower cost.

An independent firm also allows the investment advisor to choose the financial offerings he/she can make available to clients. Dealers will often limit the availability of alternative products based on their corporate needs and objectives rather than those of the investment advisor.

The Risk That Shall Not Be Named (The Lord Voldemort Risk)

On June 15, 2002, Arthur Andersen was convicted of obstruction of justice for shredding documents related to its audit of Enron, resulting in the Enron scandal. Nancy Temple (Andersen's Legal Dept.) and David Duncan (Lead Partner for the Enron account) were cited as the responsible managers in this scandal as they had given the order to shred relevant documents. Since the U.S Securities and Exchange Commission does not allow convicted felons to audit public companies, the firm agreed to surrender its CPA licences and its right to practice before the SEC on August 31, 2002 - effectively putting the firm out of business. It had already started winding down its American operations after the indictment, and many of its accountants joined other firms. The firm sold most of its American operations to KPMG, Deloitte & Touche, Ernst & Young and Grant Thornton. The damage to Andersen's reputation also destroyed the viability of the firm's international practices. Most of them were taken over by the local firms of the other major international accounting firms. (Wikipedia)

The story of Arthur Andersen should give pause to any professional who decides to pool his or her reputation with others. Senior investment advisors should understand that their reputation is tied to the actions and decisions of their colleagues and their firm's management over which they have little or no influence or control.

Though most dealers have a reasonable risk management function, the pressures of meeting business targets, accommodating investment advisors with different styles and managing dispersed operations with limited resources can strain the effectiveness of any risk management function.

An independent firm allows the investment advisor to establish his/her own business culture, financial offerings and business protocol.

Ara Compliance Support

Ara Compliance Support is a boutique firm that provides compliance support to Portfolio Managers and Exempt Market Dealers. Our focus is to help such firms reduce their compliance risk, and apply their time more efficiently. We offer a full range of services including ongoing compliance support, and compliance consulting on a project basis.

If you are thinking about starting a new Portfolio Management Firm or Exempt Market Dealer, we can also help assemble your thoughts and help organize a plan.

To discuss further, please contact us at 416-941-1263 or at info@aracompliance.com.

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