Working With a Highly Complicated Financial System

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By Alvin Clay III

I had a lunch meeting recently with a couple of investment managers from another country. They were interested in learning more about the structure of the investment business in our country, the services we provide and something about the growth prospects of the investment business in the aftermath (we hope) of the recession and market meltdown.

I explained, to the best of my ability, the difference between a stockbroker, a registered investment advisor, a financial planner, an insurance broker, a bank and the somewhat unusual structure that I managed – a state-chartered non-depository trust company.

I had to caution them that some businesses operate under multiple structures at the same time.

I explained the difference between an advisory account and a trust. Then I explained how some firms manage individual securities for their clients and how some, “open structure” firms, don’t select individual securities but rather select for their clients a portfolio of investment managers or mutual funds.

I explained how some have discretion over a client’s assets, making investment decisions and trades on behalf of their clients without receiving client approval for each transaction. Others do not have discretion and need client approval.

Then I explained the various ways people in the investment business get paid: some by commission, some by flat fee and some by a percentage of the value of their clients’ investments. We had a discussion about how the compensation structure could have an effect on the type of advice and service a client might receive.

I never got around to hidden commissions, incentive fees and layered fees. I did explain, however, that some advisors operate ethically and legally under a “fiduciary standard” through which they are bound to act independently in the best interest of the client, while others operate under a less-stringent “suitability standard.”

Somewhere in the middle of my luncheon lecture I realized how extraordinarily complicated all this was. How many investors, even “sophisticated” ones, actually understand all this? I think very few, and they are hardly to blame.

We – the industry, the regulators and the professional societies – have made a bungled mess of things.

I'm confident that most investment professionals strive to behave ethically, but how can we be sure that clients are being treated fairly if they don't understand the standards under which we give advice, the manner in which we are compensated and how we are to be held accountable?

So where do we go from here? I see three important ways to begin to address the issue.

First, as the regulators sift through the rubble, they should emphasize the need for simple, clear disclosure to the investing public. Transparency is more important that actually regulating the activities of a profession.

If consumers know what they are buying and understand the financial incentives of the investment professional, they can make their own decisions about whom they engage and for what services.

Second, until new rules apply, we in the industry should take it upon ourselves to make sure our clients know exactly what services they are paying for, and exactly how we are paid for those services.

Last, investors should not be shy about asking questions – and should not assume they already know the answers.

Investment professionals should not be insulted by questions about how they get paid and what exactly they are being paid to do.

Everyone will benefit from clarity.