HIGHTOWER
AN UNOBSTRUCTED VIEW

Independent Advice: The Optimal Advisory Firm Model

by Elliot S. Weissbluth, CEO

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ABOUT HIGHTOWER

HighTower is the first open-source, advisor-owned financial services company. HighTower advisors are experienced investment professionals with large, established practices serving high net worth and institutional clients. As a dually-registered, multi-custodial firm, HighTower provides sophisticated investment solutions as well as an independent and unobstructed view of the markets. The company is headquartered in Chicago and maintains corporate centers in New York and San Francisco and offices around the country. See *www.hightoweradvisors.com*.

ACKNOWLEDGMENTS

No document such as this one can be created without the help of many people. The authors wish to gratefully thank the following people for their invaluable contributions, and without whose broad expertise, diverse perspectives and backgrounds, and tireless efforts this white paper would not have been possible: Larry Koehler, Dan Lidawer, Greg Schulson, Matthew Reynolds, Matthias Paul Kuhlmey, Max Mintzer, Matthew Camden, Michael Papedis, Michael Parker, Kevin Geary, Michael LaMena, Regina Lahsin, Doug Brown, Dave Pottruck, Phil Purcell, Bill Doran, Ken Daley, Jennifer Connelly, and Steve Hayden.

The Evolution of the Optimal Independent Advisory Firm

The global investment environment continues to challenge the financial industry and clients alike. Private investors have yet to regain steady positioning, nor confidence in professional investment advice.

The Credit Crisis of 2008–2009 presented an exceptional challenge as the world witnessed the downfall of traditional Wall Street firms, and investors suffered significant reduction in the value of their wealth. The economic calamity included a slew of financial scandals involving elite Wall Street investors such as Bernard Madoff, R. Allen Stanford, and even the venerable wire house, Goldman Sachs. During the resulting Wall Street reform by Washington policymakers, it has become apparent that many "trusted" financial advisors, including stockbrokers and insurance agents, do not have a duty or obligation to consider their clients' interests ahead of their own.

In the aftermath of the Great Depression, Americans radically altered their view of the banking system. Similarly, in today's environment, investors have become more suspicious, and have begun to interrogate the many different facets of Wall Street financial service firms. Worldwide, investors have come to the realization that many, so-called, financial advisors are little more than salespeople, generating profit for their firms even while the capital of their clients dwindles. These revelations have sparked a renaissance in the financial services industry, a dramatic shift in practice that, while responding directly to the current crisis, represents the next step in the ongoing evolution of client-centered financial advice in the United States.

The history of the financial industry reveals a nearly 50-year evolution toward the solidification of the independent financial advisor. From its early beginnings as mutual fund salesmen turned to become financial planners, through the creation of tax shelters during the challenging '70s, the emergence of diversified portfolios in the booming '80s, fee paid asset management in the '90s, and the shift toward a client-centered fiduciary duty in the New Millennium, the independent advisory movement has been steadily growing. Today's leading independent advisor brings professional, client-centered financial advice to the mainstream public, a sophisticated luxury that was available only to the exceptionally wealthy nearly a generation ago.

The evolution of the independent advice professional, along with advancement in digital technology and decades-long financial deregulation, has led to the emergence of a new kind of optimal advisory firm. These optimal firms provide fully independent, fiduciary advisors with the resources and sophistication necessary to guide clients in even their most complex financial needs. More often, these firms are owned by financial advisors themselves, without any outside affiliations, to ensure a completely independent, client-centered approach to business. Today, clients seeking the

optimal type of advice and advisor should be asking two essential questions: 1) Is their financial advisor truly independent, owing the client an unambiguous legal duty (a "fiduciary duty") to put the client's interest ahead of his or her own? 2) Is the advisory firm sophisticated enough to deliver all of the products and services necessary to provide knowledgeable investment solutions?

The question of whether or not anyone who offers investment advice should have a fiduciary obligation is currently being discussed under the new framework of the Dodd-Frank Wall Street Reform Act at the Securities and Exchange Commission (SEC) in Washington D.C. As we will detail in a subsequent section, it is an open question whether or not the Reform Act will result in clearly and effectively addressing this concern. Nevertheless, the Act importantly identifies the issue of fiduciary duty, bringing it front and center to the attention of the public and the media.

For decades, the advisor industry has been divided into two groups: 1) client-centered advisors from smaller stand-alone practices, and 2) the more considerable, grandiose Wall Street institution. Typically, client-centered advisors are loosely organized and possess scarce resources, while the large institutions are highly organized with extensive marketing and public relations resources, and "troops" of highly compensated lobbyist and influencers.

Investors are left with a difficult decision: to choose a client-centered advisor, practicing a fiduciary standard, but most likely without the proper resources to deliver complex investment solutions, or to side with the highly sophisticated institution with little assurance that its financial skill is being used for the benefit of the client. Until recently, investors were forced to choose between these two models.

The optimal advisory firm, wedding fully independent, fiduciary advisors with the resources and sophistication necessary to guide clients in even their most complex financial needs, renders that choice obsolete. ◆

The Advantages of Independent Advice

The events of the past decade have caused many investors to rethink their investing strategies and their relationships with their "financial advisors."

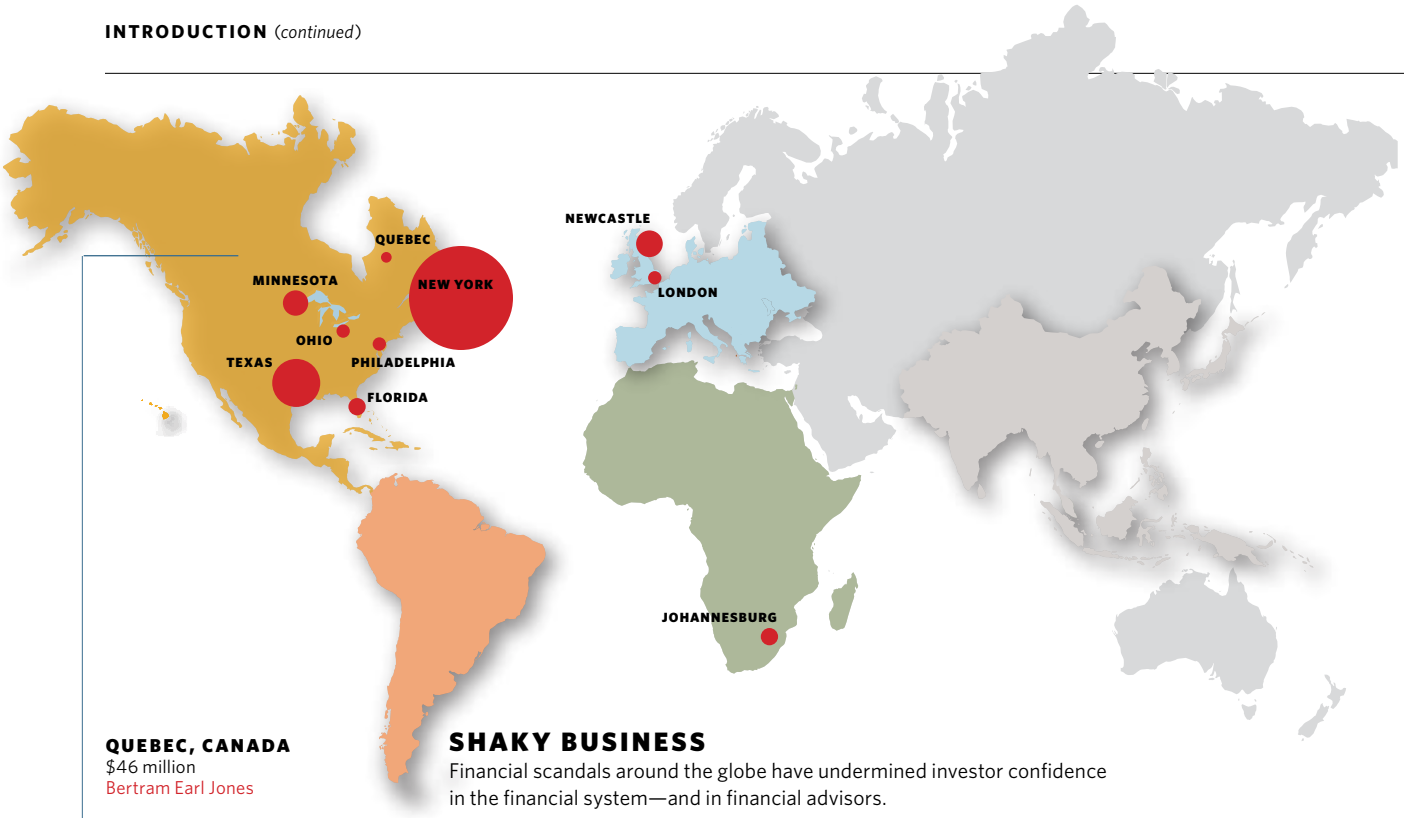
Starting with the dot-com crash in 2001, followed by the catastrophic failures of the Bear Stearns hedge funds, and culminating with the Mortgage Meltdown of 2008, investors witnessed a collapse of investment markets not seen since 1929. In several short and volatile months, all investment classes, from large cap equities to municipal bonds, lost substantial value, resulting in many investors, even those with the most diversified portfolios, losing 30–50% of their value.

With the economy already in disarray, the headlines detailing the Ponzi scheme run by securities industry icon, Bernie Madoff, as well as the empty off–shore client accounts of advisor-to-the-wealthy, R. Allen Stanford, continued to send U.S. markets in a downward-spiral. More recently, we have all watched with disappointment the Congressional hearings into how Wall Street leader, Goldman Sachs, managed—or failed to manage—its conflicts of interest in dealings with its clients.

Now that the markets have begun to recover, investors have become more wary of the debates between politicians in Washington D.C. regarding potential reforms on Wall Street. Of particular interest is the discussion surrounding whether or not all financial advisors who serve the public should have the same "fiduciary duty" to their clients that is currently only required of registered investment advisors (RIAs), pension advisors, and trust officers. Many clients, who have long entrusted their "advisors" with making ethical and sound financial decisions, are distraught to find that their stockbrokers and insurance agents, in fact, do not have such an obligation to put their clients' interests ahead of their own and their firm's interests. A study conducted in September 2010 by InfoGroup's Opinion Research Corp. revealed that 60% of retail investors erroneously believe insurance agents have a fiduciary duty to their clients; 66% erroneously think that stockbrokers have a fiduciary duty; and 76% erroneously think that anyone who calls themselves a "financial advisor," "financial planner," or "investment advisor," has a fiduciary duty.[1]

These tumultuous events have undermined investors' confidence in the financial system, leading them to question their relationship with and the duties of their own financial advisors. This renewed skepticism is healthy for investors, as it encourages a greater understanding of who their financial advisors truly are. When it comes to selecting an appropriate financial advisor, the first question investors and the media should be asking is whether or not their advisor is truly independent. Specifically, is your advisor independent of other business, legal, and compensatory relationships that can

[1] Sources: AP, SEC, CFTC, Dept. of Justice



QUEBEC, CANADA
$46 million
Bertram Earl Jones

MINNESOTA
$3.2 billion
Tom Petters

OHIO
$50 million
Joanne Schneider

TEXAS
$8 billion
Allen Stanford

FLORIDA
$1.2 billion
Rothstein Rosenfeldt Adle

PHILADELPHIA
$50 million
Joseph S. Forte

NEW YORK
$65 billion
Bernard Madoff
$380 million
Nicholas Cosmo
$133 million
James Nicholson
$30 million
Edward T. Stein

JOHANNESBURG, SOUTH AFRICA
$1.2 billion
Barry Tannenbaum

NEWCASTLE UPON TYNE, UK
$123 million
John Potts

LONDON, UK
$62 million
Terry Freeman

SHAKY BUSINESS

Financial scandals around the globe have undermined investor confidence in the financial system—and in financial advisors.

distort their judgment? Does the financial advisor have freedom to determine what investments are appropriate for their clients? Does the financial advisor have control over the fees and expenses charged to clients? How many other departments, if any, are taking profit within the firm? Investors should also be asking whether or not the financial advisory firm is sophisticated and experienced enough to provide the necessary and relevant investment guidance for a particular client's needs. Without the right level of expertise and financial competence, independence alone cannot ensure the highest quality of investment solutions. The recent example of Goldman Sachs is a case in point. Despite being in the upper echelon of financial corporations, the firm mishandled the conflicts of interests that arose due to Goldman serving as both advisor to its clients and as a presumably neutral "market-maker" of the investments it recommended. The firm's actions are still the subject of ongoing Congressional and legal investigations. Even when an advisory firm has an upstanding reputation for its proficiency, there is no guarantee the corporation will use their investment savvy in its clients' best interest.

In today's rapidly expanding and diverse financial world, investors need the help of independent advisors who have the experience, expertise, and resources to not only recognize the everyday challenges presented by global markets, but also to provide clients with viable solutions that will enable them to meet their financial obligations and reach their financial goals.

What follows is an analysis of the structure and characteristics of the optimal financial advisory firm, one built upon the lessons of the past, designed to serve investors today and successfully navigate the uncertainties of the future. ◆

To evaluate whether your advisor is independent or not, go to p. 13 and Section III – How To Identify the Truly Independent Advisor

SECTION

How Did We Get Here?

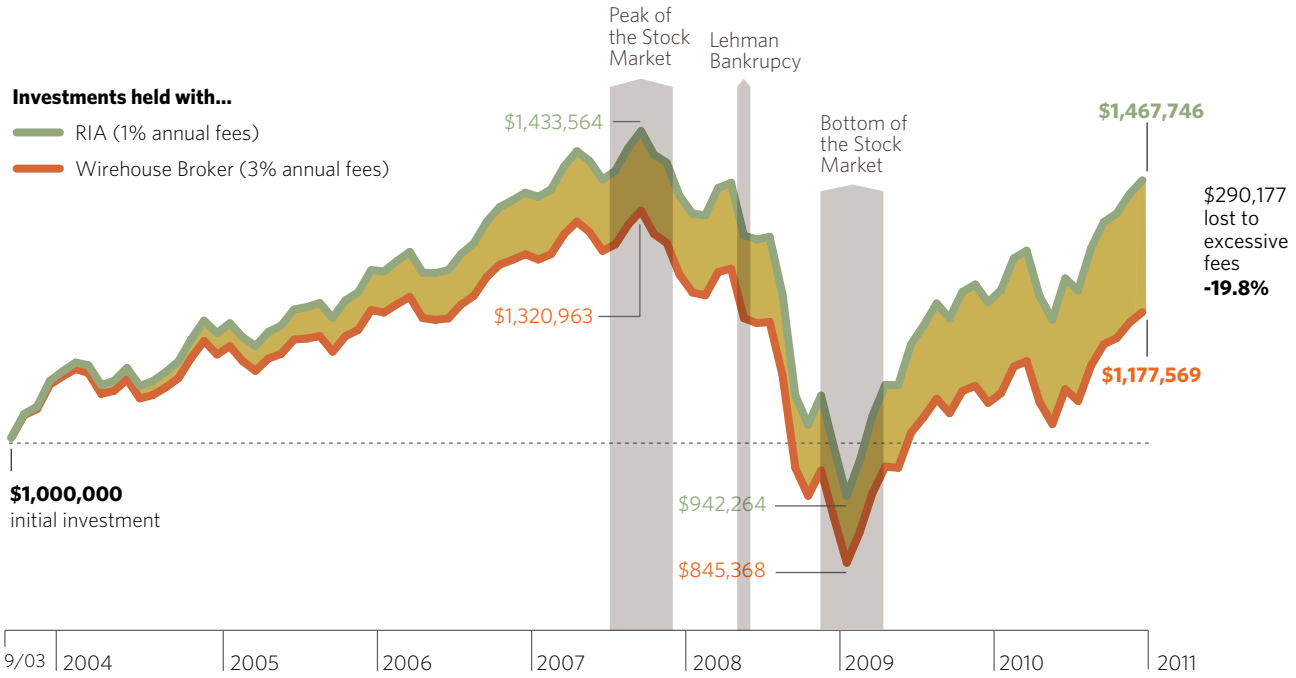
SEISMIC SHIFT

For most, change is difficult and uncomfortable. Change requires significant time, energy, resources, and most importantly, change requires a catalyst and a viable alternative. The financial services industry has been evolving over the last 50 years, changing at a pace that is comfortable to those within the industry. When the bear market of 2008 quickly evolved into the Credit Crisis and eventually the global financial system was on the brink of complete collapse, the speed of evolution within the financial industry increased. The following section outlines some of the catalysts that have led to the media's and public's realization that the previously accepted financial advisory model needs dramatic change, as well as the reasons why client-centric financial advice is now a viable alternative.

FINANCIAL PLANNING

The history and inception of the financial planning movement for the American public began in 1971. Leading this movement were mutual fund sales, which were exploding to unprecedented highs during the so-called economic "Go-Go" years of the late 1960s. However, the stock market collapsed in 1969, taking the "Nifty Fifty" (America's top 50 companies, which people believed could go nowhere but up) down with it. Shortly after the 1969 meltdown, specifically by 1971, you could not sell mutual funds to the public because of bearish economic conditions. This new principle prompted a group of formerly high-flying mutual fund salesmen to hold a meeting in the Chicago O'Hare Hilton looking for a new way of selling mutual funds during a bear market. This group would go on to form what eventually became the Financial Planning Association and the College for Financial Planning.

It was an unlikely setting for the birth of what would become genuine client-oriented financial advice, and an even more unlikely group to deliver it, yet the solution they founded—comprehensive financial planning—proved to be far more than merely a powerful new marketing tool. This group created the solutions to three major societal challenges: (1) People were living longer (driving up the costs of retirement and medical care) (2) Social Security and traditional company-funded pension plans were becoming financially unviable, and (3) an increasingly technological and mobile workforce meant people were changing jobs more frequently. The combination of these three trends, which have become even greater challenges for us today, meant that people would have to assume responsibility for their own retirement. For most, that meant the need for acute independent investment solutions from comprehensive, professional, and objective advisors who would be able to help their clients reach their financial goals.



The High Cost of Fees

Since September of 2003, a $1 million investor paying reasonable fees would have recovered from the Sub-Prime Meltdown, while an investor paying excessive fees would have made 19.8% less—and still not be back to break even.

Looking for a better way to sell financial products, the fund salesmen from Chicago started a snowball of client-oriented investment advice, which continues to gain momentum today. The idea of objective and comprehensive investment advice on complex and often arcane financial subjects resonated well with the investing public. Although these early financial planners did not realize it, they had planted the seeds of a movement that would soon expand to become a large sector in the financial industry. Every major economic downturn since then—from the Arab Oil Embargo in '73, the Collapse of '79, Black Monday in '87, the Recession of '91, to the dot-com Crash of 2001 and the Sub-Prime Meltdown in 2008—has been the cause for more clients to turn to financial advisors who have informed solutions and perspectives for navigating through the rapidly changing global economy.

FEE COMPENSATION

The next step toward developing the profession of independent advice was the large-scale conversion to fee compensation. In fact, there are strong parallels between the current fiduciary duty debate at the SEC and the movement toward fee compensation some 20 years ago. In the late 1980s, fees were emerging as a far better way for financial advisors and brokers to do business; it was as simple as the client paying the fees directly to the advisor, eliminating any confusion about for whom the financial advisor is working.

Moreover, the recurring revenues from monthly or quarterly fees charged directly on assets under management are more consistent than charging a commission on each sale. Fees also create a closer alignment between the interests of clients and financial advisors, due to the fact that as clients' assets grow, so do an advisor's fees for their management expertise. Additionally, fees that continue to be paid throughout the advisor-client relationship remove any incentive for advisors or brokers to continuously "sell something new." The fee-based financial advisor now recommends new strategies

or investments only when the financial advisor believes it will benefit the client instead of merely generating a commission.

Naturally, there was some institutional resistance to such a major change in the securities business. Initially, charging fees was associated with a minority of independent RIAs and financial planners, however, by the early 1990s, economics and client-orientation drove the fee movement to expand. Through the persistent efforts of corporate institutions such as the National Association of Personal Financial Advisors, Charles Schwab & Co., Fidelity Investments and Envestnet, the financial media joined the conversation, bringing the consumer benefits of fee compensation out to "Main Street." Once explained clearly, the fee advantage was also an easy concept for financial consumers to understand. Never ones to miss an opportunity to give clients the products they want, Wall Street hopped onto the fee bandwagon. By 1999, Merrill Lynch had converted its retail sales forces to fees, followed shortly by the other major wirehouses.

THE IMPACT OF TECHNOLOGY

The next major step toward independent advice came from the emergence of the personal desktop computer. With the aid of computers in the 1980s (and the first spreadsheet programs, VisiCalc and Lotus 123), financial advisors suddenly were able to run calculations and analyze data that had formerly been available strictly to large institutions. Due to this increased availability of technology, small advisory practices could compete with Wall Street wirehouses and major insurance companies. As a result of the competition field having the potential to level out, client-oriented financial advisors began in droves to form their own companies. In the 1990s, the Internet accelerated the ability of these smaller firms to further compete, providing access to information, research, products, and software tools that matched those of even the largest institutions. Charles Schwab and Co. launched its Schwab Financial Advisor Services (now Schwab Institutional) in 1987, enabling independent advisors to manage client relationships as if they were associated with a large institution. The development of the Internet also led to Schwab One Source—the open mutual fund marketplace that gave investors and financial advisors access to virtually all mutual funds in existence, rather than the limited menu that many brokerage firms offered. One Source was the beginning of the so-called "open architecture," where firms allowed their advisors to recommend investment products outside their own platforms and challenged the dominance of in-house "proprietary products."

Although known for their mutual funds, Fidelity Investments, through its Institutional Wealth Management Services business unit, also has made great progress enabling formerly captive brokers to migrate to the independent market where they can put their clients' interests first without the distractions and conflicts of a Wall Street brokerage firm.

A key component to the Fidelity platform is the technology developed by a Chicago firm, Envestnet. Founded by financial services visionary, Jud Bergman, Envestnet offers independent financial advisors a turnkey platform that provides access to the industry's leading independent platforms. Envestnet delivers a fully integrated, end-to-end platform, to help financial institutions and independent advisors deliver solutions to clients

of all asset levels. Their state-of-the-art, web-based platform provides access to multiple custodians, investment programs, and proposal-generating tools. These account management resources, coupled with integrated performance reporting and billing, provide independent advisors with a completely outsourced wealth management platform solution.

IRREPARABLE DAMAGE TO TRUST

Not only did clients' portfolios decline substantially during the economic crisis of 2008–2009, but trust and belief in the financial system, its regulators, investment managers, and financial advisors, also declined. We can attribute the loss of trust to three key issues: high profile scandals (Bernie Madoff and R. Allen Stanford), policy and regulation failures, and a lack of integrity from financial services companies. The recent events surrounding MF Global and the "missing" $1.6B of client funds is especially alarming as it violates the sacrosanct rule that money never be taken directly from clients' accounts. Even when Bear Sterns and Lehman Brothers were folding up, the segregated client accounts were not at risk from the firms' collapse.

The scandals provided evidence that no one could be trusted. In addition, when the regulatory bodies were unable to identify extreme fraud and deceit, investors were forced to re-evaluate everything they knew about the security of their assets.

> "investors were forced to re-evaluate everything they knew about the security of their assets."

Financial service companies also provided significant cause for concern as their actions in the creation, sale, and trading of mortgage securities provided evidence to the world that bankers were solely focused on short term gain, even at the expense of their clients. In addition to the distrustful dealings by the banks, the credit rating agencies gave subprime mortgage securities ratings that dramatically misrepresented their true risk. Internal emails from Standard and Poor's, one of the worlds largest credit rating agencies, provided tangible evidence that the credit ratings agencies knowingly gave their seal of approval to securities they felt were not worthy of investment. This increased the investing public's belief that they were playing a game that Wall Street had "rigged."

When these events culminated in the "Great Recession" and severe losses in diversified portfolios, investors were left with no choice but to distrust the financial services industry.

CONFLICTS OF INTEREST

"PROPRIETARY PRODUCTS"

The financial service industry's increasing emphasis on selling "proprietary" or "in-house" products to their investor-clients is another significant cause of rising consumer mistrust. As is well-known, large Wall Street firms often offer a broad array of such products, financial and/or investment opportunities created by the firm itself (or a subsidiary/affiliate), ranging from mutual funds to money market accounts, CDs, annuities, life insurance, etc. In comparison to regular products that sell on the open market, proprietary products are often opaque, and have higher fees than their independent counterpart. These large institutions have a myriad of ways to incentivize their advisors to recommend these products to their clients, including cash prizes for sales contests, trips, bonuses, promotions, and ultimately job security for fast-tracked careers.

"Customers believe they are being offered access to a market of products, but actually gain access only to a negatively selected and biased set of products."

An increasing sensitivity to "proprietary products," however, has resulted in heightened consumer awareness among investors, and consumers are increasingly shying away from these infamous in-house products. This has led to lower earnings for many firms, forcing them to drive replacement return while pretending to offer "open architecture," thereby extracting profits in less obvious ways. By selling a larger selection of products developed from the outside, firms appear to be acting in the better interests of their clients. But, unfortunately, many large firms offer only those outside products whose developers are willing to pay in exchange for the firms' bringing the product to market. Customers believe they are being offered access to a market of products, but actually gain access only to a negatively selected and biased set of products. In this way, firms both maintain their profit margins and claim the high ground of "open architecture." In fact, they have created yet another conflict of interest, and by failing to disclose the arrangement to the customer, yet another reason for consumer mistrust.

FIXED INCOME TRADING DESKS AND LAYERS OF PROFIT FOR THE FIRM

Interaction between a large firm's investment advisors and its fixed income, or proprietary trading, desk is yet another substantial conflict of interest in the financial service industry. Broker-dealers regularly sell to their clients products that they buy from their own firm's trading desk, severely limiting both the product and price options that the investor-client would find available on the open market.

Because the firm's trading desk is focused on its own profit and loss, it typically will mark-up the price of the finanacial products that it sells. That mark-up, then, is passed on to the investor-client, who will pay a second marked up price to compensate the advisor, thereby providing multiple layers of profit for the firm.

ADVISORY REGULATION IN TRANSITION

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") into law. Among other things, the Act promised to address the regulation of brokers and financial advisors, including the question of whether or not a uniform fiduciary duty should be applied to all financial advisors who provide investment advice to the public. Unfortunately, rather than clarify the existing legal and regulatory confusion regarding financial advisors, the Dodd-Frank Act referred the matter to the Securities and Exchange Commission (SEC) for consideration. The resulting SEC Study on Investment Advisors and Broker-Dealers, released on January 21, 2011, does indeed include strong language regarding the duty of care that all investment advisors, including brokers, owe their clients. The Study explicitly recommends that all brokers who give investment advice be held to the same fiduciary standard that investment advisors are currently compelled to uphold under the Investment Advisors Act of the 1940s. However, for reasons we will describe below, it looks increasingly as if the SEC's final ruling on fiduciary will do little to reform the regulatory regime for broker-dealers providing personal investment advice to retail investors. Regardless of the specific reforms that do or do not emerge from the legislative process, however, the issue of an investment advisor's fiduciary standard has finally been brought front and center to the attention of the media and the public.

> "When investors receive similar services from similar financial service providers, it is critical that the service providers be subject to a uniform fiduciary standard of conduct..."
>
> *Mary Schapiro*
> *SEC Chairman*
> *January 14, 2011*

Proponents of a strong fiduciary standard for brokers representing individual clients were hopeful that the SEC would issue broad new consumer protections under the Dodd-Frank Act. Much of the optimism for fiduciary standards was based upon comments made over the past year by SEC Chairman Mary Schapiro and the other four Commissioners, who seemed to believe that the time had come for a real fiduciary standard for brokers who advise the public. In her address last May to the Securities Industry and Financial Markets Association seminar, Schapiro explicitly argued in favor of a solitary standard for all broker-dealers and investment advisors. "Broker-dealers ... do not currently have to meet this standard," she acknowledged, but "broker-dealers and investment advisors providing the same services, especially to retail investors, should meet that same high fiduciary standard."

Schapiro's public support for a fiduciary standard for brokers went at least as far back as January of last year, when she testified in front of the Financial Crisis Inquiry Board on Jan. 14, stating: "When investors receive similar services from similar financial service providers, it is critical that the service providers be subject to a uniform fiduciary standard of conduct that is at least as strong as exists under the Investment Advisors Act [of 1940], and equivalent regulatory requirements, regardless of the label attached to the service providers." The Obama Administration has also shown its continued and unwavering support for a "harmonized" fiduciary standard for all investment advisors. Last July, it released a list of five key principles it considered essential for financial reform, and identified the establishment of a fiduciary duty for brokers as the most important reform.

The 2011 SEC Study, however, despite its strong language in support of a solitary fiduciary standard, is not a statement by the Commission itself, as Dodd-Frank had appeared to request. Instead, its authorship is attributed to the SEC Staff, in the form of recommendations that the Commissioners can either accept or reject, casting doubt on how firmly the Commissioners support the recommendations. Ironically, on the same day that the Study was released, two of the five SEC Commissioners, Kathleen Casey and Troy Paredes, issued a statement of their own, voicing a lack of support for its conclusions: "In our view, the Study's pervasive shortcoming is that it fails to adequately justify its recommendation that the Commission embark on fundamentally changing the regulatory regime for broker-dealers and investment advisors providing personalized investment advice to retail investors … Indeed, the Study does not identify whether retail investors are systematically being harmed or disadvantaged under one regulatory regime as compared to the other and, therefore, the Study lacks a basis to reasonably conclude that a uniform standard or harmonization would enhance investor protection." From the statement, we have to infer that these two SEC Commissioners are unlkely to support reform for changing the system of how Wall Street "advisors" currently conduct business.

Even more concerning, the Study offers the Commission great latitude in defining key concepts that could greatly weaken the consumer protections mandated by Dodd-Frank. For instance, on the issue of what constitutes "personalized investment advice," likely the only activity of brokers to fall under the standard, the Study leaves the definition and interpretation of the concept up to the Commission. "The Staff believes that such a definition at a minimum should encompass the making of a 'recommendation,' as developed under applicable broker-dealer regulation, and should not include 'impersonal investment advice' as developed under the Advisors Act." Consequently, how broadly or narrowly the SEC defines "investment advice" as given by brokers will largely determine whether or not brokerage clients will receive any meaningful new protections.

Regarding the crucial issue of a broker's potential conflict of interest, the Study's recommendation is not nearly strict enough, leaving open the possibility that a broker may meet his or her obligation merely through disclosure. The use of disclosure as a remedy for broker-dealer conflicts of interest is troubling to consumer advocates because it often has been used in the past to shift the burden of responsibility from the advisor (to eliminate or mitigate their conflicts of interest) onto the client (who must determine whether said conflicts are acceptable). Usually, the investor has insufficient information or knowledge to fully understand the potential adverse consequences of potential conflicts. A consumer advocate commenting on the SEC sanctioning disclosure as a means of meeting the fiduciary standard states, "That doesn't just weaken the fiduciary standard, it guts it."

Following the 2011 Study, the SEC has now indicated that it will issue a proposed fiduciary rule sometime in 2012. Unfortunately, recent preliminary statements by Shapiro suggest that the concerns raised above regarding the SEC Study and the statements of

> Clients receiving investment advice don't distinguish between broker-dealers and investment advisors and neither should the law.

Neal Wolin
Deputy Treasury Secretary
May 27, 2010

SEC Commissioners are well-founded. In a December 2011 Bloomberg interview, Shapiro characterized the new fiduciary rule under discussion as "business-model neutral," and stated that the new rule will likely allow brokers to continue to sell proprietary products and to charge commissions. The full implications of the SEC's "business-model neutral" approach remain to be seen, but "business-model neutral" already sounds a lot like "business-as-usual." A "hybridized," as opposed to a "harmonized," fiduciary standard is likely to create even greater confusion among investors. For a broker standard that permits sales and commissions threatens to render the term, "fiduciary duty," meaningless.

At this point, it is unlikely that the Dodd-Frank Act will result in revolutionary and substantive reform. But regardless of the final outcome, the issues have finally been brought to the media's and public's attention. In the words of Deputy Treasury Secretary Neal Wolin, "Clients receiving investment advice don't distinguish between broker-dealers and investment advisors and neither should the law." Clearly, the time has come for substantially reforming the fiduciary standard for all investment advisors.

FIDUCIARY DUTY OF ADVISORS

When viewed from the perspective of the now 50-year evolution of independent advice, what is happening in Washington today is not so much a "debate" as an acknowledgement that the fiduciary duty for advisors has won the hearts and minds of the media and investing public (just as fees did in the '90s).

As with the "fee debate," the tipping point for the fiduciary standard came when the national media finally understood the difference between financial advisors who are obligated to a fiduciary duty and those who are not. Today, while we are in the very early stages of educating most consumers on how to evaluate and select a financial advisor, large financial institutions have a strong self-interest in keeping consumers confused as to what duties are owed to them and what duties are not. This is perfectly summarized by Kathy Kristof of the *Los Angeles Times*, as she distinguishes between fiduciary myth vs. reality: "Myth: It's not clear that the system is broken. It should be studied, not fixed. Reality: Brokers and insurance agents take great pains to obscure the difference between advisors who must look out for your best interests and those who don't have to." Our current financial crisis has created an opportunity to develop policies that can clear the way for better-educated decisions, or we can simply confuse the conversation and lower the standards to appease Wall Street. ◆

SECTION

How to Identify the Truly Independent Financial Advisor

WHAT IS AN INDEPENDENT ADVISOR?

An independent advisor is free from conflicting material financial influences. If an advisor's firm is owned completely, or in part, by another company—a bank, insurance, or brokerage firm, for instance—the advisor is more likely to have legal and/or financial obligations/incentives to their employer. Independent advisors either own their own firms or work for advisory firms whose primary business and source of profit is providing investment advice to its clients; they do not generate profit from the manufacturing or distribution of financial products. On the contrary, an advisor jeopardizes independence if his or her employer generates profit from sources other than the advisory business. For example, if the firm sells insurance and underwrites securities such as IPOs or bonds, or engages in trading activities, these other business activities will create powerful financial and cultural influences that will impair an advisor's independence. These activities often create higher-than-market costs, perhaps in underperforming securities that can substantially erode investment performance over time.

A fiduciary standard is a legal duty to put the client's interests ahead of the advisor's or their firm's, to avoid conflicts of interest, and when conflicts cannot be avoided, to disclose material facts to clients so they are able to make informed decisions. Without a fiduciary duty to do what is best for their client's investments, firms and brokers may not always act in the best interest of their clients. For example, if the company makes a greater profit margin from the manufacturing of the product (asset management, banking, lending) than the sale of the product (fee paid to the broker for selling the product), the financial alignment benefits the firm, not the client.

Unfortunately, "independence" alone is not a guarantee of high quality investment service. Most "independent advisors" are running small businesses with limited levels of training, inadequate access to the best research, products, and idea generation, all of which are inferior to a large wirehouse brokerage firm. Furthermore, these small business owners are held responsible for operating their own compliance, operations, technology and other departments which distract them from analyzing market activity and making informed decisions when dealing with their clients' portfolios.

TYPES OF INVESTMENT ADVISORS

We can distinguish between different types of financial advisors according to their degree of relative "independence" from conflicting material financial influences.

DEPENDENT ADVISORS

Brokers & Traditional Brokerage Firms ("wirehouse," e.g., Merrill Lynch, Morgan Stanley, UBS) Whether they call themselves "financial advisors" or "wealth managers," brokers are typically employees of a brokerage firm and have little to no flexibility when it comes to making autonomous decisions. Under the current regulatory landscape, brokers have no legal obligation to be a fiduciary for their client; in fact, brokers are simply required to transact from a suitability standard. Brokers define what it means to be "dependent"; their compensation, computers, offices, support staff, opportunities for advancement, and even continued employment can depend on their ability and willingness to advance the best interests of their firm. All too often, short-term financial considerations can obscure the judgment of management, placing even the most client-oriented brokers in a very difficult position.

Even "fee-based" advisors or "wealth managers" within a traditional brokerage firm are conflicted because they are usually limited to purchasing securities from their "in–house" sources that have the built-in costs of their internal trading desks. These advisors are forced to purchase various products such as fixed-income securities, structured products, loans, etc. from their in-house wholesaler, instead of benefiting from a competitive market. For example, fee-based advisors within a wirehouse may only use those products on their firm's "approved list" of managers, and the firms drive additional profit by extracting fees from asset managers who want shelf-space on the firm's platform. When purchasing fixed-income securities, the typical wirehouse broker or "advisor" must purchase from the firm's fixed-income desk that sets the price for the security at the same time that they sell off the firm's own inventory of securities. All of these additional sources of profit are rarely disclosed to either the advisor or the client. Advisors are captive to internal product trading desks, manufacturers, and wholesalers, as they remain the last node in a sales distribution business seeking to drive the highest margin from the sale of the investment products.

Insurance Agents Insurance agents, often not technically W-2 employees of an insurance company, may feel the same kind of pressure as brokers stemming from companies requiring them to use exclusively the policies of one insurer or to use one company's products for the vast majority of their business .

Financial Advisors in Regional and Local Banks Financial advisors may have an assembly of their own clients, yet they are not an independent advisory service because they are employed by a bank. In a bank, usually only the trust officers operate under a fiduciary standard to place their clients' interests as a priority. In a system where the bank controls an advisor's compensation and future prospects of career progression, advisors are left with many incentives to consider what is in the bank's best interest when working with retail clients or customers.

Also, financial advisors at typical regional, local banks or credit unions are usually not as knowledgeable as their counterparts at the large brokerage firms. The banks often "white label" an investment platform with a very limited set of investment options. Further diluting investment efficacy, banks seek to remove risk by limiting their investment advisors to a platform of selected, generic model portfolios and highly constrained investment parameters. By constraining advisor operations to preconceived strategies and removing individual creativity, the banks are able to charge a healthy fee to their clients while they diminish the risk of the procedure, practically guaranteeing a mediocre investment solution.

ADVISORS WITH SOME DEGREE OF INDEPENDENCE

Independent Brokers (IBD) There are advisors who affiliate with independent broker-dealers (IBDs) otherwise known to the public as "small brokerage firms." Sometimes called financial planners or wealth managers, these advisors are technically securities–licensed stockbrokers ("registered representatives"). Unlike typical brokers, they are not employees of their brokerage firms; instead, they own and run their practices as small businesses, paying their own rent, staff compensation, and overhead. Although they still have a legal duty to represent the interests of their firm, they still own their own businesses and often have the option to affiliate with another independent broker-dealer (B/D). The influence that a brokerage firm can exert over these independent brokers is considerably reduced, leaving these advisors as not completely independent but certainly more self-regulating than traditional brokers. Despite increased independence, advisors at independent broker dealers may face "approved" lists, or are only allowed to recommend securities that are selected by the "parent firm" due to mutually lucrative partnerships. In addition, similar to many "independent advisors," independent registered reps often compromise sophistication for running their own "mom & pop" style business.

It is important to keep in mind that the terms, "financial planner" and "wealth manager," refer to an advisor's training or target clientele rather than their degree of independence. Financial planners may or may not be Certified Financial Planners, but in either case, tend to take a comprehensive approach to their clients' finances; considering a client's retirement, tax strategies, estate plan, college planning, and insurance needs, in addition to their investment portfolio. So-called "wealth managers," as the name implies, tend to focus on higher net worth clients, offering them additional services such as trust management, tax and philanthropy planning. Investors seeking an independent advisor should note that financial planners and wealth managers also could be brokers, insurance agents, bank employees, or independent advisors. Neither job description of financial planner or wealth manager gives a client any indication of the independence of an advisor or a duty to put the client's interests ahead of their own duties.

ADVISORS WITH THE HIGHEST DEGREE OF INDEPENDENCE

Registered Investment Advisors & Firms (RIA) On the "very independent" side of the spectrum of advisory firms are registered investment advisors, or RIAs. RIA firms are regulated by the Securities and Exchange Commission or their state securities administrators (not self-policed as broker-dealers are) and are required to be fiduciaries of their clients, to avoid potential conflicts of interest (such as proprietary products and sales commissions) when possible, and to disclose any conflicts that prove unavoidable. Some RIA firms are large investment companies, but in the world of retail financial advice to the investing public, most RIA firms are small businesses that are owned solely by one or two advisors. Consequently, these RIAs have a very high degree of both financial and legal independence to offer professional advice and recommend unique financial products they believe will best serve their clients' interests.

A characteristic that sets an RIA apart from brokers, insurance agents, financial planners and wealth managers, is the legal obligation—a fiduciary duty—to put their clients' interests ahead of their own. Nevertheless, paradoxically, like brokers, agents, bank employees, and some financial planners and wealth mangers, they have no requirement to be independent advisors. While many RIAs are truly independent, others work directly for brokerage firms, insurance companies, banks, or at firms owned by those institutions. Under current laws, a broker or agent could also be dually registered as a registered investment advisor. Thus, under certain circumstances, these financial advisors could be a registered investment advisor for part of a client relationship and a broker for another part of the relationship—all for the same client.

RECENT DEVELOPMENT OF RIA FIRMS

During the past 10 years, many independent RIAs determined that they could deliver even more expert advice to their clients by creating larger advisory firms, thereby acquiring broader knowledge, increased resources, and greater economic influence. This "movement" toward larger RIA firms has been accompanied by an exponential growth in technology allowing small and large practices access to the same sophisticated technology solutions that used to be only available at the large brokerage firms. A number of independent firms have recently merged, forming substantially larger RIAs. These newly formed RIAs are still considered small businesses, but with between $500 million and $4 billion in client assets under management, and generating approximately $5 million to $15 million of annual revenue, they are significantly larger than the more typical $50 million to $100 million AUM Registered Investment Advisor (the industry average RIA manages about $40 million in client assets). While these superior firms offer a broader menu of client services, often including tax advice, trust management, esoteric investment products, and business consulting, a key component to success has been the larger supporting staffs enabling advisors to focus more of their time on better serving their clients.

A disadvantage of consolidating into a larger RIA firm is often the loss of the advisors' autonomy and the boutique feel of smaller practices; the bigger the firm, the closer it is to becoming just another financial institution. Consequently, some smaller RIA firms

have followed a different path in order to acheive large firm economies of scale without losing their client-centered, high-touch focus. Instead of actually merging their practices, they have chosen to affiliate with other small firms under an umbrella RIA firm. Thus by retaining all or some of the ownership of their own firms, these advisors have gained the scope, power, and resources of a larger, more powerful firm, while remaining at the highest level of client service and independent advice.

> "The Credit Crisis and the resulting market crash in 2008 created even greater challenges for the wirehouses, accelerating the exodus of brokers switching to their own practice or to privately owned firms."

BREAKAWAY BROKERS

According to an August 2008 Aite Group Survey of Financial Advisors, more than one-third (35%) of the brokers at major firms (10,000+ brokers) are considering independence. Furthermore, 41% of potential breakaway brokers have an average client size of between $200,000 and $499,000, and 21% have clients with more than $1 million in assets.

Not surprisingly, the financial advisors considering independence have already embraced some independent practices at their respective firms. Forty-five percent of breakaway brokers already make between 25% and 50% of their client revenues from fees, and 33% of them earn more than 50% from fees. The use of proprietary products is also significantly less among breakaway brokers than with brokers who stay as employees. The Aite Group report indicated that 14% of brokers who use only in-house (proprietary) products are considering going independent while more than 33% of brokers who use third-party products are considering independence. According to the Aite Report, brokers identify the desire for greater independence in providing objective, client-oriented investment advice as well as the ability to run their firms to the utmost benefit of their clients as two of the biggest reasons for breaking away from wirehouses. Of all potential breakaway brokers, 67% said more freedom to make business and financial advising decisions is their primary reason for leaving.

ACCELERATING THE MOVE TO INDEPENDENCE

Because of the general societal trend toward taking responsibility for our own retirement, the increased availability of financial products, and a growing public understanding of the advantages of independence (objectivity, fee compensation, and a fiduciary duty), the retail brokerage industry is undergoing a significant transformation. Wirehouses have tried to reinvent themselves as wealth management firms, ostensibly shifting their focus to financial planning and building relationships with clients rather than simply selling them products.

But despite these efforts, during the past decade the major retail brokerage firms such as Merrill Lynch, Citi/Smith Barney, Wachovia Securities, Morgan Stanley and UBS have seen their once industry-dominating employee broker forces leaving the firms in a steady stream, taking many of their client relationships, and even client assets, with them. The Credit Crisis and the resulting market crash in 2008 created even greater challenges for the wirehouses, accelerating the exodus of brokers switching to their own practice or to privately owned firms. These major corporations wrote off huge amounts of debt, severely reducing their profits and capital and eroding their financial positions, resulting in industry-wide restructuring. As a result of the economic crisis and need for financial

reform, Merrill Lynch was acquired by Bank of America; Wachovia by Wells Fargo; and Morgan Stanley acquired Citi/SmithBarney's brokerage division.

Accelerated by the Mortgage Meltdown, the evolution of the independent advisory option has had an enormous effect on the traditional brokerage world and has changed the entire dynamic of the wealth management profession for good. According to a May 2009 TowerGroup Study, in the period from 2002 to 2009, the major wirehouse firms and bank broker-dealers each lost some 20% of their brokerage force, while regional broker-dealers lost 31% of their brokers, and the insurance broker force declined a whopping 40.6%. Where did these "breakaway brokers" go? While some left the industry altogether (the total number of all financial advisors declined 9.5% during this period), the vast majority went independent. Independent broker-dealers saw their financial advisor forces swell some 21.4%, while the ranks of independent RIAs grew from 25,000 to 41,500—an increase of 66.0%.

WHERE DO WE GO FROM HERE?

Independence within the financial advisory world occurs across a continuum, and gauging the level of an individual advisory firm's independence is often trickier than it seems. Only if unrestricted by outside ownership, free of material conflicting business affiliations, without outside compensation, and bound by legal duty to no one other than the client, can financial advisors truly deliver the impartial and reliable independent advice that today's financial consumers need to navigate the complexities of the investment world.

The ultimate question: Does the advisor genuinely possess the freedom and ability to act as an independent advocate on behalf of his clients? ◆

SECTION

IV

The Optimal Advisory Firm

Today's optimal advisory firm must combine genuine independence, a fiduciary duty on the part of each advisor to work only in the clients' best interests, and the infrastructure and expertise necessary to deliver the most sophisticated investment solutions.

THE BENEFITS OF THE FREEDOM OF CHOICE

Custodian firms (the institutions that actually take custody of clients' assets) can exert considerable economic pressures on an advisor to use their proprietary services (such as money market funds, trust services, and even mutual funds) in return for preferential pricing, discounts, due diligence trips, and other incentives. Larger firms can offer clients and their advisors more options to custody client assets and trade on behalf of their clients. While smaller advisors typically choose one, sometimes two, custodians with which their clients must work, larger firms can have relationships with multiple major custodians, reducing their advisors' dependence on any one custodial firm and significantly increasing their advisory and financial independence. When a firm can offer its clients a choice of custodians, the firm gains leverage by stimulating competition for their clients' business, as well as freeing himself/herself from being captive to the custodian. As a result, the firm and advisors can negotiate down many costs of doing business (e.g., trading costs, lending rates, etc.) for their clients.

Advisor-owned firms also gain further control and independence by owning their own broker-dealer. However, owning your own broker-dealer with all the necessary registrations requires material investment and size to support the day-to-day operations. Firms that successfully support operations with not one, but with multiple clearing firms, create even greater middle office complexity while also reaping the benefits of a competitive market. The addition of a brokerage option increases the services an advisory firm can offer to its clients, particularly for the high-net-worth clients who demand investment products not found on typical RIA advisory custodian platforms. Owning and operating a full service broker-dealer, however, is out of reach for most independent firms as it requires sufficient scale to afford the necessary compliance, regulatory, technology, and operational support.

In current global markets, financial advisors and investors demand sophisticated, up–to-minute precision when analyzing data upon which to make their investment allocations and choices of investment vehicles. Only truly independent advisory firms can avoid the conflicts of interest inherent in offering investment research and information while at the same time offering proprietary investment products that are created and sold by the same firm.

In addition, sophisticated investors require more than the traditional array of packaged investment products. To get a broad range of diversification and manage modern market risks, clients need access to unconventional asset classes such as high-yielding cash positions, real estate, international currencies, commodities, futures and options, hedge funds and private equity.

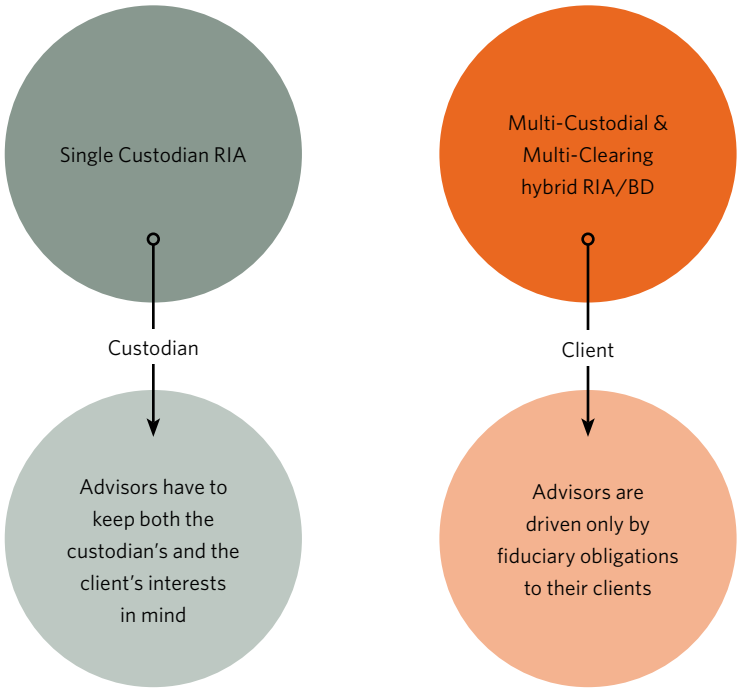
MULTI-CLEARING

Proper self regulation requires that a firm avoid the conflicts of interest and the economic pressures exerted by clearing firms and custodians. Today's financial advisors need access to the products and transaction platforms offered by multiple outside firms. By requiring outside firms to bid on executing financial transactions at the best pricing, the advisory firm maintains the control and flexibility necessary to deliver superior service to the client, without incurring the conflict of generating an internal margin on the clearing activity.

An advisor-owned broker-dealer that eliminates these conflicts is fundamentally different from a traditional representative of broker-dealers, which must generate revenues from its clearing and trading activities and conduct its business consistent with its own compliance department's assessment of risk and service. By avoiding those functions in-house, and demanding the best pricing from competing outside corporations, multi-clearing advisory firms have moved the economic power in these transactions downstream, to where it should be — in the hands of the clients and their advisors.

Genuine Independence

By working through a number of institutions, multi-clearing advisory firms enable their advisors to focus solely on the needs of their clients.



ADVISOR-OWNED

Only lawyers may own law firms; accounting firms must be owned by accountants, and medical practices by doctors. Professions have restrictions on who can own professional firms specifically to eliminate the conflicts of interest and conflicting agendas that can arise when outside institutions own businesses that give critical professional advice to the public. Financial advisory practices are no exception. The advice that financial advisors give their clients has a major impact on, among other things, their clients' financial futures, their children's education, their ability to afford healthcare, and their retirement. Just as medical patients and legal clients expect unbiased advice from these professionals, investment advisory clients need to be able to rely on independent advice from advisors that act solely in their best interests.

There is also an important distinction between an RIA who clears through another broker-dealer, and an RIA that owns its own broker-dealer (and whether or not the broker-dealer is multi-clearing). This distinction has important ramifications for the alignment of interests of the firm's middle office, the advisor and the client. Ideally, all three align to create competition in securing the best product, at the lowest cost, without any intervening or conflicting interests.

DUALLY-REGISTERED ADVISORS

Today's regulatory environment does not allow RIAs to receive remuneration for certain commercial investment activities. This limitation puts many advisors in a dilemma: Should they limit the services they provide their clients or should they refer their clients to outside brokers who are not as familiar with their financial situation and may not have their best interest at heart?

The more sophisticated advisors maintain the legal registrations they need to provide fully all the products and services their clients need and to capture the commensurate economics. Many advisors working with high-net-worth investors use various kinds of transactional products, e.g. fixed income portfolios, lending (non-purpose loans, mortgages), structured products/notes, hedging risk from concentrated positions (caps/collars, forwards, etc.), and insurance (life, annuities, etc.).

The optimal advisory firm offers a hybrid structure in order to offer its clients a broad spectrum of both advisory and investment products and services. Without dual registration, those advisors may not have access to the best investment solutions for a client's particular circumstances, or they may be forced to refer the client to an outside broker or agent (who may not adhere to the firm's high client-centered standards) to get those products.

A NATIONAL SCOPE AND SCALE

When it comes to advisory firms, it is a common misconception that the larger the firm is, the more successful and capable they are of accomplishing investment goals. It is essential that a firm have sufficient scale to support a deep and experienced staff along with a broad range of expertise, access to the most up-to-date research, state of the art technology, and resources to continually invest and improve the business. Despite these advantages, large institutions have a poor record of putting the clients' interests ahead of their own interests.

> "The optimal advisory model would combine the best of both structures: the scale and operational depth of a large firm, with the client access and service that can only come from owner advisors operating their own small, local offices."

Among the independent investment advisory firms in existence today, only a very few have a sizeable infrastructure that allows them to be able to offer professional level expertise across the broad spectrum of complex services required by today's high-net-worth investors. Most smaller advisory firms can, at best, offer bona fide expertise in only a few of the areas (research, trading, investment products, trusts and estate planning, tax, retirement, philanthropy, business management/succession planning, etc.) required by today's well-informed and prominent investors.

The optimal advisory model would combine the best of both structures: the scale and operational depth of a large firm, with the client access and service that can only come from owner advisors operating their own small, local offices that provide easily accessible, client-oriented, high-touch service.

LEVEL OF SOPHISTICATION — BROAD MENU OF SERVICES

The final major element to consider is the eminence of sophistication of an advisory firm. More importantly, very few financial firms exhibit both a high degree of independence and a high degree of sophistication. Sophistication refers to much more than an individual advisor's training, experience, or skill. Rather, the true measurement of an individual firm's level of sophistication rests upon the quality and depth of services it can provide to its clients.

A firm cannot adequately serve its clients if it does not offer all the services that its clients need to achieve their financial goals. Today's full service firms offer not only investments, retirement planning, and college planning, but help their clients with portfolio management, insurance, estate planning, tax, trust services, business consulting, accounting, and charitable giving. Firms that are too small on the operational scale, or are too narrowly focused on strict investment guidelines, often do not have the expertise to meet all of their clients' needs.

However, merely because an advisory firm maintains a high profile of complexity does not mean it is using that investment savvy in its clients' best interest. Many of the wirehouse firms employ some of the smartest traders, bankers, and investment professionals, but the question an investor needs to ask is whether that investment expertise benefits them or benefits the firm. The modern optimal advisory firms need to have access to a plethora of resources that enable them to make well-informed investment decisions to best service their clients' interests and goals.

INDEPENDENCE IS BETTER BUSINESS

Armed with more powerful technologies such as financial planning models, superior databases of research, financial products, and a system by which advisors easily compute client fees, independent financial advisors are asking themselves why they need to affiliate with a wirehouse. As growing numbers of financial advisors set up their own firms, either as RIAs or with an independent broker/ dealer affiliation, it has become clear that independent advisory practices actually represent more sound business models.

Large brokerage firms, bloated with middle management and layers of expenses, are exerting more and more pressure to increase profits and reduce costs, often at the client's expense. For instance, at large brokerage firms advisors typically are allotted a specific number of support staff, based on assets under management or annual revenue. This can force advisors to reduce client service, or provide suboptimal service to their clients. When independent, the advisor assumes the role of business owner, allowing them to tailor their services, office, and staff with the client experience as their singular focus.

THE OPTIMAL ADVISORY FIRM IS AN INDEPENDENT ADVISORY FIRM

Without a duty to put the clients' interests ahead of its own, the investment solutions an advisory firm offers may have little or no benefit to its clients. In today's complex and perplexing regulatory environment, many financial firms claim to adhere to a "fiduciary duty," but where those duties start and stop often is not clear. An optimal independent advisory firm is structured to serve the needs of all investors, whether they require investment advice or simply want information and recommendations about buying and selling specific securities. ◆

SECTION

V

Conclusion

To serve clients in today's increasingly complex global markets, financial advisors need to be independent—independent of internal structural conflicts of interests and business affiliations. Most importantly, they must work under the obligation to put the clients' interests above all others. The prototypical independent advisor must possess the financial savvy to deliver high-quality financial advice, and he must maintain a national scope, offering a broad array of services, and access to investment products, dual registration, and open architecture.

The optimal independent advisory firms are built to help clients navigate the confusion created by the current legal and regulatory structures while still having access to all the investment products and services they need to reach their financial goals. Their advisors offer the highest level of client-oriented services possible, regardless of the nature of the clients' relationships with the firm—and are committed to acting in the clients' best interests (regardless of any specific legal requirements) while disclosing any conflicts of interest that might arise. Consequently, their clients can be confident that the optimal independent advisory firm and its advisors will always stand behind them to avoid the pitfalls of today's financial services industry and successfully build their own financial futures.

Finding the right independent advisor may be an arduous process, but for financial consumers, the message is simple—independent, fiduciary advisors are the only investment advisors capable of providing the advice demanded by our complex financial environment and individual client needs. ◆

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Thank you.

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