

Clearbrook Perspectives

January, 2010

Financial Services Reform: Major Reforms in Question, Investor Protections Assured



A Message from our CEO...

As we begin 2010, Clearbrook is pleased to introduce *Clearbrook Perspectives*, the first in a series of monthly commentaries on current economic, financial, investment, regulatory and policy issues of importance and interest to our clients and constituents. Our premier issue focuses on financial services reform in the U.S. and implications for clients and financial advisors.



*Rob Mooney
Chief Executive Officer*

After a tumultuous two-year period, we at Clearbrook are well aware that now, more than ever, our clients and constituents need clarity, guidance, and straightforward advice. As an independent investment advisor we are first and foremost a fiduciary. We provide objective opinions, and believe that transparency is more important than ever in the current economic environment. We appreciate your business and look forward to your feedback.

Uncertainty Around Major Issues But Certainty of Reform

It is still anyone's guess where Congress will land on what could be the most significant financial services legislation in 75 years—and still no consensus on critical issues, including the role of the Federal Reserve Board, a proposed Consumer Financial Protection Agency, and the oversight of systemically significant (“too big to fail”) institutions. The legislative agenda is crowded, the politics are getting more complex, the banks are lobbying hard, and it is historically difficult to move major legislation in an election year. That said, we believe public pressure will result in significant reforms by November. This may be an all encompassing bill or series of laws, but certainly, some reforms will pass. While banks may or may not see a new consumer regulator and mandated wind up provisions, it is likely that significant consumer protections will be enacted in both the banking and securities businesses.

For banks, these may be in addition to those recently proposed regarding overdraft fees and predatory credit card practices, which have already impacted commercial bank profitability. For brokers and investment advisors, consumer protection reforms will hold providers of financial advice to higher standards of care and lead to greater transparency and more robust disclosures to clients. Reforms are likely to further inhibit large firms from selling proprietary products and principal trading. We also believe that new regulations are likely to further encourage both client and financial advisor movement across financial service providers.

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Regulatory Harmonization will Benefit Clients

Clients of financial advisors will inevitably gain new protections with new regulations. In 2008, the Securities and Exchange Commission's (SEC's) RAND Report confirmed that since the early 1990s the boundaries between different practitioners of financial advice have blurred and, while clients do not understand the differences between advisors who work for broker-dealers and those who work for investment advisors, they expect their advisors to be acting in the client's best interest. The study actually found most clients very satisfied with their financial advisors. SEC Chairwoman, Mary Shapiro, said last year that, "If both broker-dealers and investment advisors are providing virtually identical services to retail investors. . . then the regulatory regimes that govern those activities should be virtually identical as well." Her views have been echoed by Financial Industry Regulatory Authority (FINRA) CEO, Rick Ketchum, who has said that there should be one "business model neutral" standard that should focus on each recommendation being in the "best interest of the customer." Historically, many in the independent advisor arena have been resistant to an increased focus from regulators who have mainly concentrated on the brokerage business. Just recently the House of Representatives Bill (the Wall Street Reform and Consumer Protection Act, H.R. 4173) dropped a provision that would have granted FINRA regulatory authority over independent advisors. That said, we expect that "functional regulation" will ultimately prevail and common standards will govern those who provide financial advice. There will be much debate about what those standards should be. Ultimately, however, clients will benefit by actually getting what they already seem to believe they have—a 'fiduciary' standard of care that applies to anyone who would provide them with financial advice.

Harmonization Will Impact Wirehouses and Independent Advisors Differently

Harmonized regulation will bring new compliance requirements and enforcement programs that can be expected to impact wirehouses and independent firms somewhat differently. Mary Shapiro said at the Securities Industry and Financial Markets Association (SIFMA) annual meeting, "a fiduciary standard must be coupled with an effective and, I believe, harmonized, regulatory program for broker-dealers and investment advisors." Rick Ketchum and

FINRA seem to agree and advocate first establishing a consistent fiduciary standard, "then harmonizing the oversight and enforcement of that standard and the other rules relevant to each channel." Post the Madoff and Stanford frauds, aggressive and effective enforcement is clearly a top priority for the regulators and, in this regard, all advice providers, whether independent or as part of a broker-dealer, can expect more attention. New requirements are likely to inhibit advisors in large firms by further limiting undisclosed 'cross-leverage' opportunities and proprietary and favored product distribution. However, it also is likely that large broker-dealers will be more readily adaptable to new rules because they already employ "rules based" compliance programs. New requirements are likely to force independent advisors, and those advisors in broker-dealers who are considering independence, to seriously consider how they will deal with increasing compliance requirements in the independent advisor space going forward. The Tower Group, an industry research provider, estimates that new "rules based" reporting requirements could add 10-20% more in compliance costs to independent advisors. This is likely to be a significant factor in a departing broker's consideration of going independent.

Regulators Focus on Conflicts of Interest and Product Suitability Will Improve Disclosures to Clients

In 2004, following the research and mutual fund scandals, then SEC Enforcement Director Steve Cutler, led a far reaching review of industry conflicts of interest. This resulted in most of the major Wall Street firms taking steps to better identify and disclose potential conflicts of interest, such as firm and broker compensation and fees, and to address business practices that were potentially at odds with client interests. This regulatory focus also put a spotlight on certain products and business practices, such as annuities, and sales to seniors, that has not abated. Rick Ketchum said at last year's SIFMA annual meeting, "The contemplation of a common fiduciary standard provides an important opportunity for firms to revisit their current account opening disclosure to ensure that its discussion of potential conflicts is clear, complete and in plain English." The focus on conflicts, disclosure and product suitability will undoubtedly intensify, and firms will be reviewing their conflict identification and review processes. We believe the focus on

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conflicts will be institutionalized and will lead to more and better disclosures around product features and pricing, and higher quality business practices across the industry.

Educated Clients Will Seek Diversification

We also feel, that as the dust settles on the recent financial crisis, high net worth clients are emerging wiser, having learned lessons that will drive long-term change among financial service providers. We expect increasing disclosures and transparency will lead clients to become more sensitive to cost, performance and conflicts of interest and that this will lead to pricing compression in the asset management and product origination worlds. As 'plain English' and 'food label' type disclosures become more prevalent, and as standards of care for advisors become more uniform, clients are likely to question fees, proprietary products and the motivations behind financial advice. They will likely experience more disciplined investment processes, as advisors look to uphold higher standards. In addition, clients are increasingly likely to seek diversification—not just among investments—but also in respect to where their assets are held. While larger, sophisticated clients have divided assets among different institutions for years, we believe that more clients with substantial assets will look to advisors who can provide them with centralized advice, a broader range of independent product solutions, and the ability to place their assets across multiple custodians. Further, with respect to larger clients, we believe they will continue to seek and compensate a single 'trusted advisor' with the ability to source multiple custodians and products from the open market. As the allure of association with Wall Street firms recedes, we agree with certain recruiters who have already observed clients encouraging their advisors to join the independent channel.

Conclusion

While it's hard to tell whether the most controversial components of financial services reform will be realized in 2010, it is clear that lesser reforms, focused on consumer protection in the banking, brokerage and investment advisory businesses, are being aggressively implemented by legislators and regulators eager to act in response to failures over the past two years. These reforms will promote basic investor protections, including improved disclosures and higher standards of care for financial advice providers. Long term, we

see these reforms as part of a continuing trend towards harmonized standards and greater transparency that may well lead clients and advisors away from the product driven distribution models and toward 'open source,' independent service models, even though the compliance obligations of all advisors will likely increase.

Who We Are

We are an independent investment advisory firm whose core business is to provide investment and strategic advice, investment solutions, and related wealth advisory services to institutions, individuals and financial intermediaries worldwide. As of December 31, 2009, Clearbrook Investment Consulting, a subsidiary of Clearbrook, had more than \$30 billion in client assets under advisement.

What We Do

We offer a range of investment services and solutions to institutions, family offices and private clients, and financial intermediaries. We focus on professionalism, innovation and transparency for our clients.

- Investment Consulting and Advisory Services
- Strategic Advisory Services
- Institutional Quality Manager Research
- Implemented Investment Solutions
- Access to a Broad Array of Money Managers
- Turnkey Operational and Administrative Support

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