STAYING CLEAR OF CONFLICT

Learn what is required before you're in breach of the Know-Your-Client obligation. By Ellen J. Bessner

Almost every day advisors are faced with conflicts of interest. But frequently they don't identify the conflict before a regulator or client discovers it. At that point it's too late.

Conflicts of interest come in many shapes and sizes, so it's impossible to have a system that identifies each one as it arises. But advisors possessing high ethical standards, along with sensitivity, insight and awareness of the potential for conflicts, can go far in preventing them. To develop such insight, advisors need a solid understanding of the various regulatory requirements.

Of course, an advisor's income is dependent on growing her book of business. She relies on trailer fees and commissions gleaned from buying and selling securities. However, a conflict may arise if that bottom-line interest prevails ahead of a client's needs. The issue is critical, because many advisors accused of putting their personal interests ahead of clients have indeed fallen into this situation by accident.

An advisor can grow his business in many ways, including through (but not limited to) referrals. Securing new clients via friends and family of current clients is a common growth enhancer, as is receiving additional assets from existing clients. Obviously growing a business in either of these ways isn't problematic. However, the key is to ensure these opportunities put the needs of the client first, not those of an overly ambitious advisor.

The know-your-client (KYC) obligation exists because an advisor cannot ascertain the appropriate product mix for a client without knowing his or her financial objectives and risk tolerance. Advisors who have internalized this Golden Rule will inevitably be more sensitive to red flags of conflicts of interest.

Let's say a client, Mr. Smith, has significant assets and considerable annual income. Recently he got married and he asks you to open an account for his new bride. You say you'd like to meet Mrs. Smith but he explains she's very busy, and suggests you send him the papers to open her account.

It's not uncommon for a client to try to instruct his advisor on a spouse's or a loved one's investments. Yet it is a clear breach of the KYC requirements. Growing your business in this manner exposes you to potential claims by Mrs. Smith, if her account loses money, and you may be subject to penalty by the regulator for breaching those basic obligations.

Or, say a client tells you he is the sole beneficiary of his ailing mother's estate and he is now responsible for all the investments in her account. He instructs you to make certain changes to her investments so they coincide with his own investment objectives. This is a problematic scenario as the interests of the son may not correspond with the risk tolerance of the mother. She may live for many years and have significant medical expenses. Further, if the investments do not yield sufficient income she may be faced with serious financial problems.

A conflict arises in both cases from the fact the advisor is getting instructions from a relative that conflict with the best interests of the actual client. The pressure the client places on the advisor by instructing him how to manage the actual client's account, along with the fact that fulfilling the request could benefit the advisor's pocketbook, may be in conflict with the interests of the clients and breach regulatory requirements.

Always ensure each client transaction is in accordance with the objectives and risk tolerance of the actual accountholder. This applies even if a power of attorney is in place. Otherwise it will be too late to fix the problem, and you will be at the heart of an investigation alleging, among other things, conflict of interest. AE

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