

How to Protect Yourself During Market Declines

In the wake of the recent market conditions, we checked in with Tom Giachetti, Chairman of the Securities Practice Group at Stark & Stark, a 125-attorney firm based in Princeton, N.J. He is a prominent author and commentator on investment-related legal issues and a featured speaker at many TD AMERITRADE Institutional conferences.

We talked to Mr. Giachetti in late September about the steps advisors can take to protect themselves, as well as carry out their fiduciary duties to clients.

Q. Let's start with what advisors are likely to face in the wake of a severe bear market.

A. There are two main questions here: What *should* the advisor's exposure be? And what *will* the advisor's exposure be? The advisor really should not have exposure, unless he knew or should have known there was a potential problem with an investment. But what *will* the exposure be? Clients who are litigious may try to hold an advisor responsible for any losses from their investments.

Q. What will plaintiffs' attorneys be looking for?

A. Plaintiffs' lawyers know that advisors are now a large part of the market. And when a client loses money, they want someone to pay. Generally, they want to see lost dollars, and they want to see whether the assets that were managed for the clients were suitable. The critical issue is what has the advisor done—initially and on an ongoing basis—to confirm the client's objectives.



Tom Giachetti,
Chair of the Securities
Practice Group,
Stark & Stark, PC

COMMUNICATING WITH CLIENTS

How should advisors frame conversations with their clients in a difficult market? Here's what Tom Giachetti recommends:

"When you speak to your clients, they're likely to be nervous and upset. You should be careful not to defend yourself. Listen to the client—really listen. They're looking to you to address their concerns. You can let them know you continue to monitor events; unfortunately, many of those events are outside your control. You can find out if they want to make any changes. If they're intent on changing any of their objectives, get that in writing from the client."

Q. So they're going to look at various client-advisor documents.

A. Yes, they'll look at the client agreement, the questionnaire, the investment policy statement—anything that sets forth the parameters of the account and advises the client as to the risks associated with it. Don't get tripped up by your own documents.

Q. What should advisors be reviewing in their documents?

A. First, if it's not confirmed in writing, the advisor could have, depending on the situation, an uphill battle. Any questionnaires should be filled out in the clients' own handwriting. Make sure they put the checkmarks in the boxes on any list of questions. I've seen too many times where an advisor has filled out a questionnaire on behalf of the client. Or it's not even signed by the client. If it's not signed, it's not formally accepted.

Q. How should an investment policy statement be used?

A. Keep it short and simple, no more than three pages. Only elicit the information you really need. Make it very clear whether there are any restrictions on any types of investments the client may invest in. Make clear what the time horizon is and define any terms that are used like "conservative," "moderate," or "aggressive." Tell the client what you're going to do and how you'll do it.

Q. What about questions that deal with a client's expected returns?

A. Those types of questions can be dangerous. That's why the client comes to you, so you can determine what is a realistic return based on their objectives. If on page 2 you ask, "How much do you want to make?" and on page 3 you ask, "How much are you willing to lose?" there's going to be a disconnect. The client typically wants to make more than they can, given their risk parameters. If you ask those questions, you've got a questionnaire that's going to come back to haunt you.

Q. You also tell advisors to check the language they use in marketing brochures and other materials.

A. The marketing brochure is usually warm and fuzzy. It has terms like "we treat you like family" or "we provide comprehensive financial planning." These can be minefields. Many times they don't jibe with what you actually do. You need to have qualifiers in even the most common phrases. Don't say "we meet with clients on a regular basis." Say "we offer to meet with clients on

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An Action List for Advisors

Given the unprecedented and rapid-fire events in the financial markets, the editors of *IM Insight News* put together a list of actions for advisors. Not all of these may apply to your particular firm, but the suggestions give you a variety of steps you can take to make sure your firm is doing its best to watch out for clients.

□ **Identify troubled companies.** Consider starting a master list of troubled issuers. Perhaps assign a junior employee to keep a close eye on the news. Or, do as the savvy hedge fund managers are doing and monitor spreads on credit default swaps (CDS), which can serve as an early indicator that an issuer is running into trouble.

□ **Identify troubled positions.** Determine the extent to which your firm and clients hold securities of troubled issuers. Discuss any holdings in the financial industry with your firm's portfolio managers. Make sure they, and you, have a good understanding of why the investment was made, when it was made, and the portfolio manager's current view on the holding. Consider documenting this review. Ascertain whether there is any backup or research file for the holdings to document why the investment was believed to be appropriate.

□ **Assess any counterparty risk.** Evaluate the extent to which your firm has exposure to counterparties that are, or may be, in trouble. Again, CDS spreads may be a good mechanism for identifying what the market thinks of your counterparty. Consider putting together a matrix to map your firm's total exposure in terms of business arrangements and outstanding contracts.

□ **Review client accounts.** Check client accounts for any concentrated positions, particularly in non-discretionary accounts and accounts that recently have been transferred to your firm. Consider whether to contact the client and discuss the position. If you do, keep a log of

that contact. Consider whether to seek a temporary grant of discretion from non-discretionary accounts, given rapidly changing market conditions. If your firm has relied on a Lehman Brothers index for any reason, it may be a good time to go find another index.

□ **Avoiding rumors.** Consider increasing scrutiny of emails and instant messages (IMs). Look for indicia of insider trading, market manipulation, and the spreading of false rumors. Identify positions that are doing very well or very poorly, and search for communications discussing those positions. Consider sending a compliance reminder to employees alerting them to the fact that regulators have heightened their focus on market manipulation.

□ **Review your disclosures.** Consider to what extent you should educate your clients about the recent events. Unlike most securities professionals, your average client or investor may not have been following events on Wall Street 24/7. Identify whether recent client letters or market commentaries have expressed views or opinions that may now need to

be updated. Include your firm's website as part of this review. If short selling is a material strategy for your firm or fund, disclosures about the SEC's actions may be warranted.

□ **Securities lending.** If your firm engages in securities lending (through a securities lending agent for mutual funds or through a prime broker for hedge funds), review the agreement and your firm's (or the fund's) securities lending policy. Determine which securities are currently being lent out, and to whom. Consider whether you can get the securities back if you choose to recall them. With the SEC's new locate requirements, certain securities may be in much higher demand. Consider whether any securities may need to be recalled in order to protect the value of the securities for your clients. Assess the entity to whom the security is being lent to for counterparty risk. Make sure that you are aware of the monitoring process for collateral, and, if you can, try to determine whether the value of collateral continues to be adequate (especially if the collateral takes the form of something other than a government security).

□ **Money market funds.** Identify any money market funds into which your clients' excess cash is swept. If the fund manager is providing daily transparency, consider monitoring the portfolio holdings and the daily outflows. If the fund manager is not providing daily transparency, consider requesting it.

□ **Derivatives.** Review derivatives contracts to determine whether any of the recent events, including the actions of the U.S. government, have triggered termination or other rights. Make sure you know the specific entity that is the counterparty to your contracts. Consider making any collateral or margin calls that you are eligible for.

□ **Fund of funds or manager of managers.** Evaluate whether any of your underlying funds or underlying managers have the potential for a large

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WHEN CLIENTS CALL

One of the most critical steps you can take—and one that is fairly simple to devise—is to develop a consistent process for handling inquiries. You should first determine whether to centralize responses to inquiries from clients, investors, and consultants about the impact of market events on accounts, exposure to specific companies, and/or general economic issues. You should also decide who within your firm should regularly handle such inquiries.

In addition, consider whether to prepare daily written exposure sheets, either for internal reference or public disclosure. Remind your firm's client service employees that there should be no guarantees of performance. If your firm has a portfolio holdings disclosure policy, review it to determine the parameters of what can be discussed, and whether changes to the holdings disclosure policy need to be made given the exigent circumstances.

Finally, consider whether all oral communications should be followed up with a template email or letter to ensure that your firm is delivering a consistent message.

Be Careful With Third-Party Evaluations

A coffee cup that says you're the world's greatest Mom or Dad does not make that statement an established fact (as much as you know you are!). Likewise, investment advisors must be extremely careful when using third-party ratings in advertisements and marketing materials. The danger is that ratings might be viewed as testimonials or could be construed as being false or misleading if they are used improperly.

When recognition can be misleading

There are a number of publications and services that bestow honors on investment advisors, such as a list of top wealth managers or best financial advisors. When an advisor receives recognition of this kind, the firm must recognize the potential compliance issues before referring to the award in advertisements and marketing materials.

As most advisors are aware, Rule 206(4)-1 under the Investment Advisers Act of 1940 contains restrictions on advertisements by investment advisors. Pursuant to that rule, advisors may not use testimonials in advertisements. Furthermore, advertisements may not be false or misleading in any way.

In a December 2, 2005 no-action letter to the Investment Adviser Association (IAA), SEC staff expressed the opinion that "third-party ratings that rely in part on client evaluations are not necessarily testimonials for purposes of rule 206(4)-1(a)(1). Whether a third-party rating is a testimonial depends upon all of the facts and circumstances relating to the rating." Certain ratings are testimonials, because they are implicit statements of clients' experience with an advisor.

Depending upon the particular facts and circumstances of the situation, third-party ratings based primarily on client evaluations may be permissible if:

- The ratings do not emphasize favorable client responses or ignore unfavorable ones
- The rating represents all, or a statistically valid sample, of the responses received from an advisor's clients.

It is also important to look at factors such as the objectivity and structure of the questionnaire sent to clients.

If responses from clients are an insignificant factor in the rating's formulation, it is less likely to be viewed as a testimonial. However, even if an advisor advertises a rating and it is not a testimonial, the advertisement might still be false or misleading. In its no-action letter to the IAA, the SEC identified a number of factors that are useful in determining whether an advertisement containing a third-party rating (including a testimonial) is false or misleading. Those factors are:

- Whether the ad discloses the criteria on which the rating was based
- Whether a firm advertises a favorable rating without disclosing any facts that the advisor knows would call into question the validity of the rating or the appropriateness of using it in advertisements
- Whether an advisor advertises any favorable rating without also disclosing any unfavorable ones

- Whether the advertisement states or implies that an advisor was the highest rated in a category and wasn't
- Whether the ad clearly and prominently discloses the category for which the rating was calculated, the number of advisors surveyed in that category, and the percentage of advisors receiving that rating
- Whether the ad discloses that the rating may not reflect any one client's experience with the advisor
- Whether the ad discloses that the rating may not be indicative of the investment advisor's future performance, and
- Whether the ad discloses prominently who created and conducted the survey and whether advisors paid a fee to be included.

Fully disclose the ratings

Third-party ratings from organizations and publications are essentially meaningless if there is no disclosure of the criteria on which they are based. In many instances, advisors advertise ratings in marketing materials and on websites with no indication as to when they received this recognition. Frequently, the ranking is from years earlier, and a key person may no longer be with the firm. The advisor often fails to mention that the firm has not been recognized more recently by the publication or rating service.

Without full disclosure of the criteria for ranking investment advisors, potential clients may be misled. For example *Worth* magazine's list of the "Nation's Top 100 Wealth Advisors" requires advisors to fill out an online questionnaire as the initial step in the selection process. It should be disclosed in advertisements referring to this rating that not all investment advisors participate in the process. Otherwise, potential clients might believe that every advisor in the country was evaluated.

In contrast to third-party ratings that are derived from painstaking analysis of meaningful data, some recognition can be attained simply with a check or credit card payment. A local magazine, for example,

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CONSIDER THIS DISCLOSURE

Assuming the rating your firm receives from a third-party organization or publication is legitimate, some variation of the following disclosure might be a good starting point in any advertisement or marketing material:

Third-party rankings and recognition from rating services or publications are no guarantee of future investment success. Working with a highly rated advisor does not ensure that a client or prospective client will experience a higher level of performance or results. These ratings should not be construed as an endorsement of the advisor by any client nor are they representative of any one client's evaluation. Generally, ratings, rankings, and recognition are based on information prepared and submitted by the advisor. A more thorough disclosure of the criteria used in making these rankings is attached or available by clicking on this link.

The disclosure should be tailored to the rating and how it was formulated.

COVER STORY

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a regular basis." Many times clients don't want to meet with you. You have to watch out for adjectives and vague promises.

Q. Besides removing certain phrases, what language should advisors definitely have in their documents?

A. The onus should be on the client to notify you if anything has changed in their objectives for their account, or if they have any new restrictions for an account. That instruction should be in every client agreement, in your regular quarterly statement, your Form ADV. Fortunately, the industry has pretty much adopted that standard, so most advisors do it.

Q. So let's say an advisor wants to get in touch with clients to "clean up" their documents. Won't that set off alarm bells with the client, whom they want to reassure?

A. It's a sensitive issue to do that now. I can appreciate that. But there are ways to do it without alarming the client. You can say it's times like these that make us look at our risk sensitivities and our objectives. And if there have been any changes, we are here to address them.

Q. How about emails from clients? What should advisors do to avoid problems?

A. When the plaintiffs' attorney or the SEC comes calling, they'll want to see all your emails. And although you may not save all of them, your clients do. So stop committing everything to electronic history. Get off your addiction to your BlackBerry. Don't answer a client's email question with an email; tell them you'll call them. And then get on the phone.

Q. What should an advisor do if a call turns hostile?

A. The last thing most clients want is to be embroiled in an adversarial conversation.

But if something does come up that worries you about the client, you should speak to counsel. For two reasons: first, you need to determine if the situation has risen to the level of an official complaint. Second, if it has, you have to report it to the insurance company that handles your E&O insurance. You could jeopardize your coverage if you fail to timely report a complaint.

Q. Should advisors be reviewing their E&O policies?


A. Definitely. They should read it carefully, especially the pages that describe what's excluded. Many policies are limited in scope. They may, for instance, only cover mutual funds, but not ETFs, which are securities. And many policies do not cover recommendations of private investment vehicles, such as hedge funds and private equity.

Q. How much E&O coverage should an advisor carry?

A. Advisors typically have \$1 million or \$2 million in coverage. My general recommendation is to look at the amount of assets you have under management, whether or not you provide financial planning for those assets. Whatever coverage you have, you may want to increase it. And don't get the cheapest policy. Use a higher deductible and you can obtain more coverage. Remember, a \$5,000 claim won't wipe you out, but a \$2 million claim could.

Q. When should advisors consult an attorney on a potential compliance or fiduciary question?

A. There's a big difference between talking to a counselor and talking to someone who provides compliance documents. There's no privilege rule with a consultant. You will need to seek competent legal advice if you face a serious issue. Correspondence, compliance reviews, and verbal communications between an

advisory firm and a non-law firm provider are not privileged. They are subject to turnover, disclosure, or production during a regulatory proceeding, including a compliance examination, or a client lawsuit or arbitration proceeding. 


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ACTION LIST

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negative impact from the new regulatory restrictions.


Follow your valuation policies. You do have valuation policies, right?

Prepare for the worst. Consider various doomsday scenarios. How could your firm best position itself to deal with the potential fallout? 

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MARKETING

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might offer advisors the opportunity to purchase an ad in a publication that names them as one of the best advisory firms in the area. If the only requirement for receiving that award is paying for the ad, the advertisement would certainly seem to be false or misleading. 

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