

and

## A Call For A Professional Regulatory Organization for Personal Financial Advisors

If we could design the world anew – how would we make it? That is the opportunity that exists when one talks of reform of our financial regulatory system. But closer scrutiny reveals that the future may not deliver on the golden promise of a better world. Rather, the endless march of greed underlies much of the motivation behind talk of financial services reform.

### RECENT DEVELOPMENTS.

#### *The Return of Fee-Based Brokerage Accounts?*

The Rand Report has been released, and the SEC is moving toward proposals to reform broker-dealer and investment adviser legislation. Public comments from SEC staff members indicate that one proposal, likely to be advanced, is to provide the SEC with additional authority to provide exemptions from the application of the Investment Advisers Act of 1940. Such authority, if granted by Congress, would likely lead to the return of fee-based brokerage accounts.

#### *SRO For Investment Advisers – Can Anyone Spell F-I-N-R-A?*

The Treasury Department's blueprint for reform recommended a self-regulatory organization for investment advisers. And one lobbyist in Washington has heard from three separate sources that FINRA has studied the issue of regulating investment advisers

(despite FINRA's ongoing denials to the contrary).

**12b-1 Fees.** Reports suggest that the SEC is going to time-limit the 0.75% portion of 12b-1 fees, and may seek to rename them. Of course this will lead to new problems. Just as when a deferred contingent sales charge expires there is often a rush to exchange the annuity by the salesperson, so will there also be a rush to sell an old fund, and purchase a new one, when the 12b-1 fee is about to expire. Furthermore, there is no indication that the SEC will address one of the major problems with 12b-1 fees – namely that they are being utilized as “investment advisory fees in drag.”

**FPA Voices Concerns.** The FPA has voiced its opposition to a self-regulatory organization for investment advisers. In addition, some FPA representatives have vocally expressed their concerns over the “two hats” SEC proposed

rule. There is no question that the FPA wants financial planning to move ahead and become a profession of fiduciaries, but at times the FPA is not as vocal on the issues as it could be, given its diverse membership. Still, the FPA's leadership on fiduciary issues, and its access to policymakers, should not be underestimated.

**CFP Board – Mixed Signals.** With its move to Washington, DC, during the second half of 2007, the CFP Board of Standards rapidly staffed up, pulling in some experience from FINRA. Following a meeting with the general counsel and/or chief compliance officers of several large broker-dealer firms, the CFP Board later issued a revised and expanded “Frequently Asked Questions.” In doing so, the CFP Board attempts to navigate narrow waters. Think consumers are confused as to when fiduciary duties apply? Imagine being the CCO of a broker-dealer firm seeking to apply the “FAQs.”

Will the CFP Board, now that its staff is back in place, devote some of its significant resources toward advancing financial planners as professionals? There appears to be support within the organization for just such a course, but time will tell.

**NAPFA Asserts Itself.** NAPFA continues to be active and vocal. NAPFA issued a formal response to the Rand Report, pointing out several mistakes in the Report and challenging its major conclusion. In addition NAPFA filed extensive comments on the SEC's summary prospectus proposed rule, calling for disclosure of all fees and costs. As an organization of fiduciary-only personal financial advisors, NAPFA can often advocate strongly in support of fiduciary duties, since it does not have to worry about offending its membership.

**SIFMA Attacks The Fiduciary Standard of Conduct.** Recently SIFMA's representatives have asserted to both federal and state securities regulators that the fiduciary standard of conduct is too “nebulous” – much more so than the standard of “suitability.” Hence, they argue, the fiduciary standard should be abandoned.

What is most interesting, and confounding, is the argument by broker-dealer firms and their proxy (SIFMA) that the suitability standard, which has been subjected to much litigation (and hence has a “body of case law” built up around it), is therefore more protective of consumers than the fiduciary standard of conduct.

SIFMA and its hired guns should take a course in deductive reasoning and logic. SIFMA argues that “Since A is not fully defined, even though it is a much better for consumers, we should embrace B, even though it is much worse for individual investors.”

Perhaps instead we should explore the reasons behind the lack of definition of the suitability standard. Inattention to the application of the Advisers Act by securities regulators, especially as fiduciary advisors have emerged in greater numbers in recent decades. Also, mandatory arbitration means very few cases involving fiduciary duties escape to the courts, and fewer still make their way into reported judicial decisions. In addition, FINRA arbitration only recently required arbitrators to put their decisions, and the rationale for them, in writing – yet such decisions are still not made freely available to the public for review and analysis. If we are going to refine fiduciary standards of conduct through the development of case law, the arbitration process and decisions arising therefrom must become much more transparent, and much more independent.

I would myself opine that fiduciary standards of conduct should be more defined, as they are applied to investment advisers and financial planners. In fact, various efforts, such as ISO 22222 standards, AIF and CEPEX certifications, and the CFP Board's revised Rules of Conduct, seek to better define the main fiduciary standards of due care, loyalty, and utmost good faith. More can be done, however. Personal financial advisors need a more comprehensive set of professional rules of conduct. (See my article, "What are the Specific Fiduciary Duties?," under the "Advisor" section of the FiduciaryNow.com web site, for a draft example of same.) Gaining the full trust of the public will require that personal financial advisors further define, and apply, fiduciary duties to their activities. But, simply because work remains to be done in this area does not mean we should abandon fiduciary standards.

At recent meetings with regulators I was asked to opine on the key differences between "suitability" and fiduciary standards of conduct, as they are applied to the delivery of financial services. As they affect consumers, two key distinctions stand out. The first is the duty to ensure that total fees and costs are reasonable. The second is the duty to consider taxes in connection with financial planning and investment decisions.

Most of the people who want to give consumers advice about investments are not held to a very high standard. At best, they're held to a "suitability" standard, which means they're supposed to reasonably believe that the investment and insurance products they want the investor to buy are appropriate for that investor's situation. And, generally speaking, that means there is no duty to ensure that the total fees and costs of the investment product are kept reasonable. Nor is there any duty to ensure that the investment portfolio is structured tax-efficiently, or even that tax-efficient products are utilized in taxable accounts. "Suitability" roughly

translates to "just "appropriate" – not "the best choice" nor "in the client's best interests."

By contrast, a fiduciary personal financial advisor knows that high total fees and costs translate to lower investment returns for investors the vast majority of the time. This does not mean that the absolute lowest cost investment product must be recommended. But it does mean, in the context of investment product due diligence, that a product with higher costs must possess other attributes which merit its inclusion in an investment portfolio. Good judgment must be exercised in reviewing an investment product's attributes. "Lifting the hood" during investment product due diligence is required, in order to discern (or at least estimate) the often "hidden" costs of pooled investment vehicles.

Is there a duty to consider taxes? If they are material to the consumer's rate of return, then the answer is an unqualified "yes." A fiduciary personal financial advisor must advise his or her client in a manner which, over the long term, reduces the tax drag upon investment returns.

So, let's return to SIFMA's argument. SIFMA asserts that the suitability standard, which addresses mainly the risk of any particular product at the time of its sale, is better for investors because it is so "defined." This is so even though the suitability standard of conduct permits the non-fiduciary to sell expensive and tax-inappropriate products to individual investors.

***The anatomy of the cockroach may be simpler and easier to understand than the anatomy of a human being, but that does not mean we should rush to embrace the cockroach over our fellow humans.***

The views expressed in this document are those of the author only. They do not necessarily reflect the views of any organization or firm to which the author belongs.

This document is Copyright © 2008 by Ron A. Rhoades, JD, CFP®. All rights reserved.

The large wirehouse firms, and others who manufacture products, resist the fiduciary standard of conduct at every turn. Why is this so? The reason is economic – pure and simple. It results in lowering of fees and costs to customers. This results in lower profit for the large firms which engage in product sales. Also, adopting a fiduciary standard of conduct means that “financial consultants” will have to be trained much more extensively – not just in how to sell a product, but also in income tax law and the tools and techniques of real financial planning. Such training is costly and expensive, further cutting into the profits of the large broker-dealer firms. Simply put, the fiduciary model of serving clients is less profitable for SIFMA’s members, and SIFMA knows it.

Adopting a fiduciary standard of conduct results in substantial disintermediation. Often when industries are faced with the threat of intermediation they resort to government to stem the tide, through the adoption of laws and/or regulations which thwart progress. The “Merrill Lynch Rule” which permitted fee-based brokerage accounts, not governed by a fiduciary standard of conduct, was the prime example of such. Others exist, such as the SEC’s proposed rule permitting “two hats.” This begs the question - do federal securities regulators know that they are being utilized as a pawn in such manner – to stem progress in the regulation of financial services?

American consumers deserve better. They are entitled to receive the protections of the fiduciary standard of conduct – the highest standard of conduct under the law. They are entitled to truly objective investment advice, if that is what they seek.

Yet, in an attempt to preserve an archaic system of distribution of expensive products, SIFMA and its members seek to confuse regulators. The illogic of their positions should receive close scrutiny, and their substantial economic motivations to distort the issues should be closely examined.

Billions and billions of dollars a year are needlessly diverted away from individual investors and to product manufacturers and their sales representatives. And Wall Street firms have done such a good job of hiding these fees and costs, that 30% of those surveyed in the Rand Report thought they never paid their “financial consultant” any fees, ever.

Everyone deserves reasonable compensation, at least when they deliver quality advice. But there is no reason to continue to see excessive fees and costs continue, to the detriment of the financial future of our own fellow citizens.

We should be racing to the top – adopting the fiduciary standard of conduct for all those who provide investment and personal financial advice. Instead, SIFMA and their members firms prefer a race to the bottom. SIFMA’s illogical arguments should be countered at every turn.

## ***A PROPOSAL FOR A PROFESSIONAL REGULATORY ORGANIZATION FOR PERSONAL FINANCIAL ADVISORS***

While those concerned about these issues should continue to advocate for broader application of the Investment Advisers Act of 1940, as Congress intended, such advocacy is in opposition to the SEC's recent rule-making efforts. Given the ongoing movement in Washington to lessen fiduciary protections for consumers of investment advisory and financial advisory services, it is time to look for a different path to fiduciary status for all personal financial advisors.

Hence, it is time to embrace the concept of a *professional regulatory organization (PRO)* for personal financial advisors. No other avenue is likely to be effective in moving "financial planning" toward status as a true profession. To achieve status as a true profession will require legislation, as exclusivity to practice is essential to preserve the status of the profession in the minds of consumers. Such legislation is most likely to occur at the state level.

We must recognize that professional status is not an inherent right by qualifications only. Professional status is conferred by society through a legislative grant of trust. To gain this legislative grant, the public must believe and see the professionals to be trustworthy. The public must believe that the professionals will utilize their status as fiduciaries for the benefit of their clients and for the good of society at large.

Armed with recognition that personal financial advisors desire an elevated place in our society, reflective of a high degree of trust, as professionals, then the first question we must ask is - what are the specific attributes of such a profession?

### **Attributes of a True Profession**

***Professional Independence.*** The training and the work based on this body of knowledge is controlled and organized by one or more professional regulatory organization(s) which, through appropriate legislation, are relatively independent of the state (politics) and capital (economic forces).

***Body of Knowledge – Expertise.*** A profession recognizes a discrete body of knowledge and skills, which is important to preserve, regulate, propagate and develop for the common good of society. The profession limits the practice of

this knowledge to men and women of good standing only, as unscrupulous persons practicing these skills can lead to significant harm to the profession.

***Education and Training.*** Admission to the profession requires a long period of education and training. The profession controls the entry criteria. The profession controls the content of the required training and requirements for its completion. The profession adopts appropriate continuing education standards.

**Legal Aspects; Exclusivity.** Through appropriate legislation, the profession possesses exclusive rights to practice, regulate and propagate in this area of knowledge. The mandates of the professional regulatory organization are formalized by enabling legislation and the adoption of an appropriate set of bylaws for the organization.

**Public Purpose.** The profession is expected by the society to provide leadership, address problem and offer solutions in this area of expertise for the common good of society. Because of this exclusive right to practice within this body of knowledge the society expects professionals will gain their livelihood by providing service to the public in the area of expertise.

**Reasonable Fees, Fully Disclosed.** The professional is entitled to professional fees in the delivery of the service. No particular form of fee payment is mandated, provided that: (1) all fees and material compensation are fully disclosed; and (2) the fees should be commensurate to the level of service or complexity of the work involved. Professionals are to value performance above rewards and are held to a higher standard of behavior than non-professionals and businessmen.

**Professional Regulation and Ethics.** The profession is governed by its own code of ethics (i.e., rules of professional conduct) in addition to the normal laws of the land. The profession is responsible for the technical and ethical criteria by which their members are evaluated and regulated. The profession has the right and duty to discipline unprofessional conduct.

## How Do We Achieve Professional Status?

If personal financial advisors truly desire to establish themselves as a profession, it will take time and concerted, sustained effort. It will not result from the actions of any one individual, nor any one organization. It will require leadership from the most senior leaders (and past leaders) of our industry organizations. It will require dedication from individuals who were present nearly four decades ago at the profession's origins, as well as those who have recently joined the practice of financial planning.

What is required? I suggest a series of **action steps** which will likely be needed to sustain a successful effort toward establishment of personal financial advisors as members of a true profession.

**Lobbying of State Regulators and Legislators** - for the enactment of the proposed legislation and rules necessary for recognition of the profession. It is suggested that just one, or a few, states be tackled at a time, in an organized lobbying effort, at least initially. Support of

NASAA should be sought, as well as support of various consumer organizations.

**Drafting Model Legislation** - for the purposes of advancing state and/or federal sanctioning of financial planning as a regulated profession. There are a lot of different structures which can

be utilized to support a profession. For example, should a national board of standards exist? Should peer review be conducted under the oversight of state securities regulators, or independently by professionals themselves? (The CFP Board recently encountered a similar issue, leading to the resignation of several dedicated members from its board of professional review.) How is the profession defined? What exclusions should be provided to other professionals (attorneys, CPAs, etc.)? Where will the lines be drawn between conduct subject to professional standards and sales activities? What terms will be confined exclusively to use by the profession?

***Drafting Model “Rules of Professional Conduct”*** - for adoption by the profession, including commentary thereto for purposes of elaboration on the rules for the education of members. The ISO 22222 standards, the FPA Fiduciary Task Force Final Report, the CFP Board’s revised standards of conduct, the rules of conduct adopted by other professional organizations, and other resources can be utilized as foundational materials for the development of these Rules. There are many aspects of the rules which require development, including: (1) What is the extent to which the scope of the engagement can be limited by the personal financial advisor? (2) What is the duty of the personal financial advisor with respect to ensuring that the total fees and costs related to the delivery of personal financial advice and investment solutions remain reasonable? (3) What guidelines can be established for personal financial advisors to adhere to their fiduciary duties while receiving commissions (such as the concept of “disclosed and agreed-to-in-advance compensation” prior to the specific product recommendation)? In other words, how can

the fiduciary standards of conduct be adhered to under various business models which currently exist within the securities industry? (4) To what degree must a personal financial advisor provide tax advice in connection with the planning and/or investment recommendations? (5) What is “diligence” in the context of review of a financial product for possible recommendation to any client? (6) What is “diligence” in terms of information-gathering preliminary to undertaking a financial plan? (7) What disclosures and standards of conduct are required should proprietary funds or other products be offered (can they be offered, and if so, under what standard)?

***Submitting Comment Letters To The SEC, Other Federal Government Agencies Or Departments, Congress, And State Legislators And Regulators*** - on issues directly related to fiduciary standards of conduct and their application to the emerging profession of personal financial advisors. One cannot advocate for a PRO and stand idly by while federal laws and/or regulations move in the opposite direction. Opposition to SRO regulation (i.e., FINRA) of personal financial planners / investment advisers will be necessary. And opposition must also occur to efforts by the SEC to obtain greater authority to provide exemptive relief from the requirements of the Investment Advisers Act of 1940 may be required, in the interim.

***Sponsoring And Hosting An Annual “Fiduciary Forum” Or “Personal Financial Planner Forum” In Washington*** – either alone or in connection with other industry and consumer organizations - with invitations extended to federal/state policy makers to speak at the event, and invitations to federal/state regulators and legislators.

## A Coalition Is Needed ... Now, Not Later.

Let us pause first and recognize that the formation of a true profession is not just about prestige. It is also about accepting limitations on conduct – through acceptance of the fiduciary duty to act in the best interests of the client at all times. It is about taking on the stewardship of our clients' hopes, goals and dreams. It is also about undertaking a substantial ongoing contribution to our society. It is about earning, and then retaining, the trust of our society.

It has long been known that most Americans are woefully unprepared for the financial challenges which await them in their future years. Indeed, at a time when four out of five Americans believe that the United States is headed down the wrong path, leadership is required at many levels. Part of that leadership will be to embrace a fiduciary model for serving consumers who seek out objective financial and investment counsel.

**In the months ahead you may hear of formal efforts to advance personal financial planning toward status as a true profession. If and when you do, I encourage you to reach out and support these efforts.**

**It is time** for financial planners / personal financial advisors to come together in a formal coalition.

**It is time** for the industry organizations which promote personal financial advice (CFP Board, FPA, NAPFA) to unite behind and support such a coalition, for the limited purpose of sustaining a long-lasting effort to achieve true professional status.

**It is time** for each of you to get involved, and stay involved, in some way, in order for us all to achieve these worthwhile goals. We, personal financial advisor professionals, deserve the accomplishment of these goals. Our clients deserve it. America deserves it.

- *Thank you to many for your continued support and encouragement.*

Ron A. Rhoades, JD, CFP®, Editor, FiduciaryNow.com