The Market for Retirement Financial Advice

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OXFORD
UNIVERSITY PRESS

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Great Clarendon Street, Oxford, OX2 6DP,
United Kingdom

Oxford University Press is a department of the University of Oxford.
It furthers the University's objective of excellence in research, scholarship,
and education by publishing worldwide. Oxford is a registered trade mark of
Oxford University Press in the UK and in certain other countries

First Edition published in 2013

Impression: 1

Published in the United States of America by Oxford University Press
198 Madison Avenue, New York, NY 10016, United States of America

British Library Cataloguing in Publication Data
Data available

Library of Congress Cataloging in Publication Data
Data available

ISBN 978–0–19–968377–2

Printed in Great Britain by
CPI Group (UK) Ltd, Croydon, CR0 4YY

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Chapter 14

Regulating Financial Planners: Assessing the Current System and Some Alternatives[1]

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Consumers are increasingly turning to professionals who describe themselves as financial planners for assistance with a broad range of services (Turner and Muir, 2013). Although there is no statutory or unique definition of financial planning, it can be broadly defined as a systematic process that individuals use to develop and achieve their financial goals. Financial planning typically involves a variety of services including preparing financial plans for clients based on their financial circumstances and objectives, and making recommendations for specific actions clients may take. In many cases, financial planners also help implement these recommendations by, for example, providing insurance products, securities, or other investments, selecting the right balance of stocks and bonds for an investment portfolio, choosing among insurance products, and providing tax and estate planning. Some financial planning organizations have raised concerns that no single law governs providers of financial planning services, broadly describing this situation as a 'regulatory gap' (Financial Planning Coalition, 2009). There are also concerns that financial planners may have an inherent conflict of interest in recommending products they may stand to benefit from selling (GAO, 2010*a*). In addition, some believe consumers may be confused by the numerous titles and designations that financial planners can use (GAO, 2010*a*).

In this chapter, we first review US federal and state laws and regulations that apply to financial planners and their activities. Next we assess the comprehensiveness and effectiveness of the regulatory structure for financial planners, and we discuss some key consumer protection challenges—in particular, consumers' understanding of the applicable standard of care and the titles and designations that financial planners use. We conclude with a presentation of some of the advantages and disadvantages of four alternative approaches to the regulation of financial planners.

Financial planners are primarily regulated under investment adviser laws

While there is no specific direct regulation of 'financial planners' per se at the federal or state levels, the activities of financial planners in the United States are regulated under federal and state laws as well as by regulations governing investment advisers—that is, individuals or firms that provide investment advice about securities for compensation. The Securities and Exchange Commission (SEC) has issued guidance that broadly interprets the Investment Advisers Act of 1940 (Advisers Act) to apply to most financial planners, because the advisory services they offer clients typically include providing advice about securities for compensation. States take a similar approach on the application of investment adviser laws to financial planners and, as a result, they usually register and oversee financial planners as investment advisers.

The SEC and state securities departments share responsibility for the oversight of investment advisers in accordance with the Advisers Act. The SEC generally oversees investment advisor firms that manage $100 million or more in client assets, while the states oversee those that manage less. The SEC's supervision of investment adviser firms includes evaluating their compliance with federal securities laws by conducting examinations of firms—including reviewing disclosures made to customers—and investigating and imposing sanctions for violations of securities laws. According to SEC staff, in its examinations the agency takes specific steps to review the financial planning services of investment advisers (GAO, 2010*a*). For example, the SEC may review a sample of financial plans that the firm prepared for its customers, to check whether the firm's advice and investment recommendations are consistent with customers' goals, the contract with the firm, and the firm's disclosures. Yet the frequency with which the SEC conducts these examinations varies, largely because of resource constraints faced by the agency. GAO (2007) has noted that harmful practices could go undetected because investment adviser firms rated less risky are unlikely to undergo routine examinations within a reasonable period of time, if at all. More recently, the SEC stated in a staff report that, as a result of growth in the investment adviser industry and a reduction in SEC enforcement staff, the agency 'likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency' (SEC, 2011*a*: 3–4).

State oversight of investment adviser firms generally includes activities similar to those undertaken by the SEC, including specific steps to review firm financial planning services. States generally register not just investment adviser firms but also investment adviser representatives—that is,

individuals who provide investment advice and work for a state- or federally registered investment adviser firm.

Financial planners can also be subject to broker-dealer and insurance laws, and to marketing and disclosure rules

In addition to providing advisory services such as developing a financial plan, financial planners generally help clients implement their plans by making specific recommendations, and by selling securities, insurance products, and other investments. SEC data show that, as of October 2010, 19 percent of investment adviser firms that provided financial planning services also provided brokerage services, and 27 percent provided insurance (GAO, 2010*b*).

Broker-dealers

Financial planners that provide brokerage services such as buying or selling stocks, bonds, or mutual fund shares, are subject to broker-dealer regulation at the federal and state levels. At the federal level, the SEC oversees US broker-dealers, and the SEC's oversight is supplemented by self-regulatory organizations (SROs), including the Financial Industry Regulatory Authority (FINRA). State securities offices work in conjunction with the SEC and FINRA to regulate securities firms. Salespersons working for broker-dealers are subject to state registration requirements, including examinations. The SEC and SROs examined about half of broker-dealers in 2009, the most recent year for which these data are readily available.

Insurance agents

The states are generally responsible for regulating the business of insurance. Financial planners that sell insurance products, such as life insurance or annuities, must be licensed by the states to sell these products and are subject to state insurance regulation. Financial planners that sell variable insurance products, such as variable life insurance or variable annuities, are subject to both state insurance regulation and broker-dealer regulation, because these products are regulated as both securities and insurance products. Yet the GAO (2009) has reported that the effectiveness of market conduct regulation, such as examination of the sales practices and behavior of insurers, may be limited by a lack of reciprocity and uniformity, which may lead to uneven consumer protection across states. That is, the extent to

which state regulators accept other states' regulatory actions may vary, and not all states have implemented the same, or substantially similar, regulatory standards or procedures.

Marketing and disclosures

The SEC and FINRA have regulations on advertising and standards of communication that apply to the strategies used by investment adviser firms and broker-dealers to market their financial planning services. In addition, the SEC and state securities agencies regulate information that investment advisers are required to disclose to their clients. In the Uniform Application for Investment Adviser Registration, known as Form ADV, regulators have typically required investment adviser firms to provide new and prospective clients with background information, such as the basis of the advisory fees, types of services provided (such as financial planning services), and other information.

Existing regulation covers most financial planning services

Although there is no single stand-alone regulatory body with oversight of financial planners in the United States, the regulatory structure for financial planners covers most activities in which they engage. As discussed above and summarized in Figure 14.1, a financial planner's primary activities are subject to regulation at the federal or state level primarily via regulation pertaining to investment advisers, broker-dealers, and insurance agents. In interviews with GAO in 2010, staff at the SEC, FINRA, state securities regulators, financial industry representatives, consumer groups, and academic and subject matter experts expressed a belief that, in general, the regulatory structure for financial planners was comprehensive. This was largely because, as noted earlier, the activities a financial planner normally engages in generally include advice related to securities, and such activities make financial planners subject to regulation under the Advisers Act. Providing financial planning services would be difficult without offering investment advice or considering securities, and holding even broad discussions of securities—for example, what proportion of a portfolio should be invested in stocks—would require registration as an investment adviser. In theory, a financial planner might offer only services that do not fall under existing regulatory regimes (e.g., advice on household budgeting) but this is likely rare and such a business model may be hard to sustain. Furthermore, to the extent that financial planners offer services

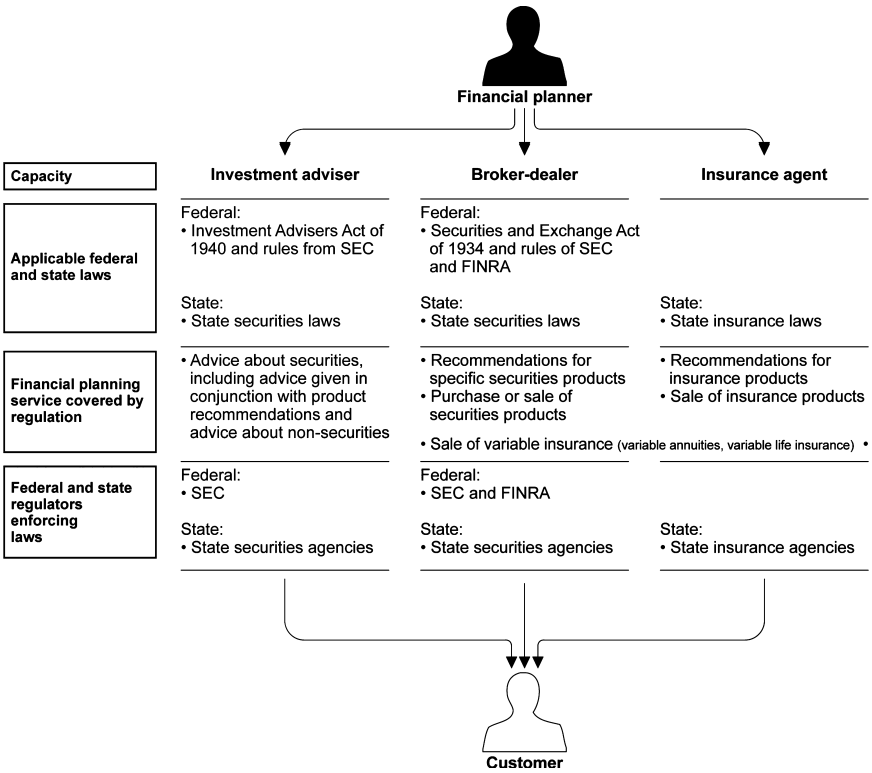

Figure 14.1 Summary of key statutes and regulations that can apply to financial planners

Source: GAO (2011).

that do not fall under such regulation, the Consumer Financial Protection Bureau potentially could have jurisdiction over such services.[2]

Some disagree that regulation of financial planners is as comprehensive as it should be. The Financial Planning Coalition (2009) contends that a regulatory gap exists because no single law governs the delivery of the broad array of financial advice to the public. The group posits that the provision of integrated financial advice is unregulated, including topics such as selecting and managing investments, income taxes, saving for college, home ownership, retirement, insurance, and estate planning. Instead, it argues that there is patchwork regulation of financial planning advice, and it sees as problematic having two sets of laws—one regulating the provision of investment advice, and the other regulating the sale of products. In addition, certain professionals (including attorneys, certified public accountants, broker-dealers, and teachers) who provide financial

planning advice are exempt from regulation under the Advisers Act, if such advice is 'solely incidental' to their other business activities. According to an SEC staff interpretation, this exemption would not apply to individuals who held themselves out to the public as providing financial planning services, and it would apply only to individuals who provided specific investment advice in rare, isolated, and non-periodic instances. Banks and bank employees are also excluded from the Advisers Act and are subject to separate banking regulation.

While the regulatory structure for financial planners may be deemed comprehensive by many, enforcement of existing statute and regulation has been variable. As noted earlier, examination of SEC-supervised investment advisers is infrequent and market conduct regulation of insurers is inconsistent. Some industry representatives have argued that a better alternative to additional regulation of financial planners would be increased enforcement of existing law and regulation, particularly related to fraud and unfair trade practices (GAO, 2010*a*).

Consumers may not understand that financial planners have potential conflicts of interest when selling products

As illustrated in Figure 14.2, financial planners are subject to different standards of care in their capacities as investment advisers, broker-dealers, and insurance agents. We describe these in turn.

Fiduciary standard of care

Investment advisers are subject to a fiduciary standard of care: that is, they must act in their client's best interests, ensure that recommended investments are suitable for the client, and disclose to the client any material conflicts of interest. This fiduciary standard applies even when investment advisers provide advice or recommendations about products other than securities, such as insurance, in conjunction with advice about securities.

Suitability standard of care when recommending security products

FINRA regulation requires broker-dealers to adhere to a suitability standard when rendering investment recommendations. Hence, they must recommend only those securities that they reasonably believe are suitable for the customer. Unlike the fiduciary standard, suitability rules do not

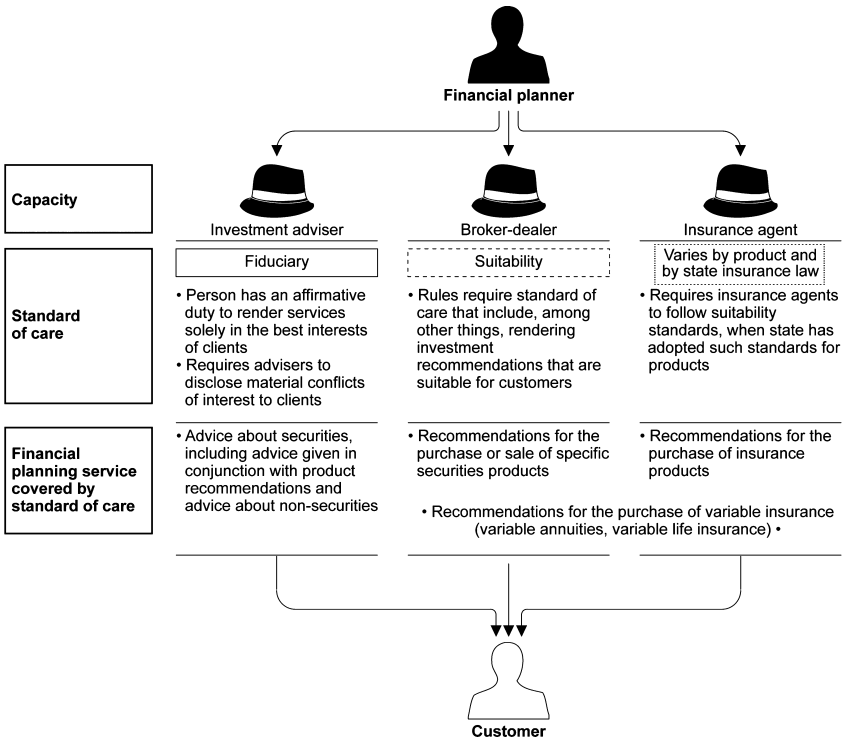

Figure 14.2 Differences in the standards of care required of financial planners
Source: GAO (2011).

necessarily require that the client's best interest be served. Up-front general disclosure of a broker-dealer's business activities and relationships that may cause conflicts of interest is not required, though broker-dealers are subject to many FINRA rules that require disclosure of conflicts in certain situations, even when those rules may not cover every possible conflict of interest, and disclosure may occur after conflicted advice has already been given.

Suitability standard of care when recommending insurance products

Standards of care for the recommendation and sale of insurance products vary by product and by state. For example, the National Association of Insurance Commissioners' model regulations on the suitability standard for annuity transactions (NAIC, 2010), adopted by some states but not

others, require consideration of the insurance needs and financial objectives of the customer. Its model regulation for life insurance (NAIC, 2005) does not include a suitability requirement per se.

Conflicts of interest can exist when, for example, a financial services professional earns a commission on a product sold to a client. Under the fiduciary standard applicable to investment advisers, financial planners must mitigate potential conflicts of interest and disclose any that remain. But under a suitability standard applicable to broker-dealers, conflicts of interest may exist and generally may not need to be disclosed up-front. For example, financial planners functioning as broker-dealers may recommend a product that provides them with a higher commission than a similar product with a lower commission, as long as the product is suitable and the broker-dealer complies with other requirements. Because the same individual or firm can offer a variety of services to a client—a practice sometimes referred to as 'hat switching'—these services could be subject to different standards of care. This raises concerns that consumers may not fully understand which standard of care, if any, applies to a financial professional during a given transaction.

Financial services firms that provide financial planning argue that clients are sufficiently informed about the differing roles and accompanying standards of care that a firm representative may have. They note that when they provide both advisory and transactional services to the same customer, each service—such as planning, brokerage, or insurance sales—is accompanied by a separate contract or agreement with the customer. These agreements disclose that the firm's representatives have different obligations to the customer depending on their roles. Once a financial plan has been provided, some companies have customers sign an additional agreement stating that the financial planning relationship with the firm has ended. In addition, the SEC and FINRA have certain disclosure requirements designed to inform consumers of firms' conflicts of interest, compensation, business activities, and disciplinary information, all intended to help consumers evaluate investment advisers' integrity.

Nonetheless, the SEC (2011*b*) has observed that many investors find the standards of care confusing and do not appear to understand the differences between investment advisors and broker-dealers or the standards of care that apply to them. In the same way, the Financial Planning Association has noted how difficult it would be for an individual investor to discern when the adviser was acting in a fiduciary or a non-fiduciary capacity. Others have similarly found that consumers generally do not understand the distinction between a suitability and fiduciary standard of care, and when financial professionals are required or not required to put their client's interest ahead of their own (Hung et al., 2008; Infogroup, 2010; Hung and Yoong, 2013). In a staff report, SEC (2011*b*) has recommended a uniform fiduciary

standard of care, whereby the standard of care for all brokers, dealers, and investment advisers, when providing investment advice about securities to retail customers, would be to act in the best interest of the customer without regard to their own financial or other interests.

Consumer confusion on standards of care may also be a source of concern with regard to the sale of some insurance products. A 2010 national survey of investors found that 60 percent mistakenly believed that insurance agents had a fiduciary duty to their clients (Infogroup, 2010). Some insurance products, such as annuities, are complex and can be difficult to understand, and annuity sales practices have drawn complaints from consumers and various regulatory actions from state regulators as well as SEC and FINRA for many years (CRS, 2010). Some states have requirements that insurance salespersons sell annuities only if the product is suitable for the customer, while others do not. Consumer groups and others have stated that high sales commissions on certain insurance products including annuities may provide salespersons with a substantial financial incentive to sell these products, which may or may not be in the consumer's best interest.

Consumers may be confused about financial planners' titles and designations

Individuals who provide financial planning services use a variety of titles when presenting themselves to the public, including financial planner, financial consultant, and financial adviser, among many others. FINRA has identified more than 100 professional designations, five of which include the term 'financial planner,' and 24 of which contain comparable terms such as financial consultant or counselor. Given the large number of designations for financial planners, consumers may have difficulty distinguishing among them, and even experienced investors are confused about the titles used by broker-dealers and investment advisers, including financial planner and financial adviser (Hung et al., 2008; Hung and Yoong, 2013). In consumer focus groups held by the SEC, participants were generally unclear about the distinctions among titles, including broker, investment adviser, and financial planner (Siegel & Gale LLC and Gelb Consulting Group, 2005). In addition, concerns have long existed that some financial professionals use titles suggesting that they provide financial planning services as a marketing tool, when in fact they are only selling products. The Financial Planning Coalition (2009) has noted that some individuals may hold themselves out as financial planners without meeting minimum training or ethical requirements.

Financial planners' professional designations are typically conferred by a professional or trade organization. These designations—such as Certified Financial Planner®, Chartered Financial Consultant®, or Personal Financial Specialist—may indicate that a planner has passed an examination, met certain educational requirements, or had related professional experience. Some of these designations require extensive classroom training and examination requirements and include codes of ethics with the ability to remove the designation in the event of violations (Turner and Muir, 2013). State securities regulators view certain designations as meeting or exceeding the registration requirements for investment adviser representatives and allow these professional designations to satisfy necessary competency requirements for prospective investment adviser representatives. Nevertheless, the criteria used by organizations granting professional designations for financial professionals vary greatly. Privately conferred designations range from those with rigorous competency, practice, and ethical standards and enforcement, to those that can be obtained with minimal effort and no ongoing evaluation. 'Senior-specific designations' that imply expertise or special training in advising elderly investors have received particular attention from state regulators of late, as a result of cases in which financial professionals targeted seniors by using such designations to wrongly imply they had a particular expertise for older investors (SEC et al., 2007). In response, some states now limit the use of senior-specific designations.

SEC-registered investment advisers must follow SEC regulations on advertising and other communications prohibiting false or misleading advertisements, and these regulations apply to investment advisers' marketing of financial planning services. FINRA regulations on standards for communication with the public similarly prohibit false, exaggerated, unwarranted, or misleading statements or claims by broker-dealers, and broker-dealer advertisements are subject to additional approval, filing, and recordkeeping requirements and review procedures. In addition, most states regulate the use of the title 'financial planner,' and state securities and insurance laws can apply to the misuse of this title and other titles. In many states, regulators can use unfair trade practice laws to prohibit insurance agents from holding themselves out as financial planners, when in fact they are purely engaged in the sale of life or annuity insurance products. But the effectiveness of the regulation of insurers' market conduct varies across states, and GAO (2010*c*) has noted inconsistencies in the state regulation of life settlements, a potentially high-risk transaction in which financial planners may participate.

Some stakeholders have recommended alternative approaches to the regulation of financial planners

Over the past few years, a number of stakeholders, including consumer groups, FINRA, and trade associations representing financial planners, securities firms, and insurance firms, have proposed different approaches to the regulation of financial planners. Following are four of the most prominent approaches, and some of their potential advantages and disadvantages.

Creation of a board to oversee financial planners

In 2009, the Financial Planning Coalition, comprised of the Certified Financial Planner Board of Standards, the Financial Planning Association, and the National Association of Personal Financial Advisors, proposed that Congress establish a professional standards-setting oversight board for financial planners (Financial Planning Coalition, 2009). The coalition's proposed legislation would establish federal regulation of financial planners by allowing the SEC to recognize a financial planner oversight board that would set professional standards for and oversee the activities of individual financial planners, although not financial planning firms. For example, such a board would have the authority to establish baseline competency standards in the areas of education, examination, and continuing education, and it would be required to establish ethical standards designed to prevent fraudulent and manipulative acts and practices. It would also have the authority to require registration or licensing of financial planners and to perform investigative and disciplinary actions. The Financial Planning Coalition contends that a potential advantage of this approach is that it would treat financial planning as a distinct profession and regulate across the full spectrum of activities in which financial planners may engage, including activities related to investments, taxes, education, retirement planning, estate planning, insurance, and household budgeting. A financial planning oversight board could also help ensure high standards and consistent regulation for all financial planners by establishing common standards for competency, professional practices, and ethics.

Nevertheless, many securities regulators and financial services trade associations believe that such a board would overlap with and in many ways duplicate existing state and federal regulations, which already cover virtually all of the products and services that a financial planner provides (GAO, 2010*a*). The board could also entail unnecessary additional financial costs and administrative burdens for the government and regulated entities. In addition, some opponents of this approach question whether

'financial planning' should be thought of as a distinct profession requiring its own regulatory structure, noting that financial planning is not easily defined and can span multiple professions including accounting, insurance, investment advice, and law.

Augmenting oversight of investment advisers with an SRO

Several proposals over the years have considered having FINRA or a newly created SRO supplement SEC oversight of investment advisers. These proposals date back to at least 1963, when the SEC recommended that all registered investment advisers be required to be members of an SRO. In 1986, the National Association of Securities Dealers, a predecessor to FINRA, explored the feasibility of examining the investment advisory activities of members who were also registered as investment advisers. The US House of Representatives passed a bill in 1993 that would have amended the Advisers Act to authorize the creation of an 'inspection only' SRO for investment advisers, although the bill did not become law. In 2011, the SEC (2011*b*) released a staff study recommending that Congress consider new approaches to address the SEC's insufficient resources for examining investment advisers. Among them were authorizing one or more SROs to examine all SEC-registered investment advisors, or authorizing FINRA to examine investment advisers dually registered as broker-dealers for compliance with the Adviser's Act.

According to FINRA, the primary advantage of augmenting investment adviser oversight with an SRO is that doing so would allow for more frequent examinations, given the limited resources of states and the SEC. The Financial Services Institute, an advocacy organization for independent broker-dealers and financial advisers, has stated that an industry-funded SRO with the resources necessary to appropriately supervise and examine all investment advisers would close the existing gap between the regulation of broker-dealers and investment advisers (GAO, 2010*a*). Yet some state securities regulators oppose adding an SRO component to the regulatory authority of investment advisers, believing that investment adviser regulation is a governmental function that should not be outsourced to a private, third-party organization lacking the objectivity, independence, expertise, and experience of a government regulator. Furthermore, SROs are less transparent than government regulators inasmuch as they are not subject to open records laws through which the investing public can obtain information. In addition, funding an SRO and complying with its rules could impose additional costs on firms.

Extending coverage of the fiduciary standard

As noted earlier, the SEC (2011*b*) recommended extending coverage of the fiduciary standard of care to all brokers, dealers, and investment advisers. Proponents of extending the fiduciary standard of care, including consumer groups, some financial planning groups, and some state regulators, generally maintain that consumers should be able to expect that financial professionals they work with will act in their best interests (GAO, 2010*a*). They say that a fiduciary standard is more protective of consumers' interests than a suitability standard, which requires only that a product be suitable for a consumer rather than in the consumer's best interest. In addition, extending a fiduciary standard could somewhat reduce consumer confusion about financial planners that are covered by the fiduciary standard in some capacities (such as providing investment advice) but not in others (such as selling a product).

Yet some participants in the insurance and broker-dealer industries still argue that the fiduciary standard of care is vague and undefined (GAO, 2010*a*). They say that replacing a suitability standard with a fiduciary standard could actually weaken consumer protections because the suitability of a product is easier to define and enforce. Opponents also have argued that complying with a fiduciary standard would increase compliance costs that in turn would be passed along to consumers or otherwise lead to fewer consumer choices (GAO, 2010*a*).

Clarifying financial planners' credentials and standards

The American College, a non-profit educational institution that confers several financial designations, has proposed clarifying the credentials and standards of financial professionals, including financial planners (GAO, 2010*a*). In particular, it has suggested creating a working group of existing academic and practice experts to establish voluntary credentialing standards for financial professionals. Clarifying the credentials and standards of financial professionals could conceivably take the form of prohibiting the use of certain designations or establishing minimum education, testing, or work experience requirements needed to obtain a designation. The American College suggests that greater oversight of such credentials and standards could provide a 'seal of approval' that would generally raise the quality and competence of financial professionals, including financial planners, help consumers distinguish among the various credentials, and screen out less-qualified or reputable players.

Yet the ultimate effectiveness of such an approach is not clear, because the extent to which consumers take designations into account when

selecting or working with financial planners is unknown, as is the extent of the harm caused by misleading designations. In addition, implementation and ongoing monitoring of financial planners' credentials and standards could be challenging. Moreover, the issue of unclear designations has already been addressed to some extent—for example, as noted earlier, some states regulate the use of certain senior-specific designations and allow certain professional designations to satisfy necessary competency requirements for prospective investment adviser representatives. State securities regulators also have the authority to pursue the misleading use of credentials through their existing antifraud authority.

Conclusion

This chapter has argued that existing statutes and regulations appear to cover most, if not all, financial planning services in the United States, and individual financial planners nearly always fall under one or more regulatory regimes, depending on their activities. While no single law governs the broad array of activities in which financial planners may engage, an additional layer of regulation specific to financial planners may not be warranted at this time. At the same time, more robust enforcement of existing laws would strengthen oversight efforts.

Financial markets function best when consumers understand how financial providers and products work and know how to choose among them. Yet consumers may be unclear about standards of care that apply to financial professionals, particularly when the same individual or firm offers multiple services that have differing standards of care. As such, consumers may not always know whether and when a financial planner is required to serve their best interests. In addition, consumer confusion about standard of care remains a concern with regard to advice on, and sale of, insurance products, which is largely outside the jurisdiction of the SEC. Finally, we have seen that financial planners can adopt a variety of titles and designations that can imply different types of qualifications, yet consumers may not understand or distinguish among these designations, leaving them unable to properly assess the qualifications and expertise of financial planners. The SEC, FINRA, and state regulators have all taken actions in recent years to address this issue, but how successful they will be remains to be seen.

Endnotes

1. The present chapter draws heavily on the GAO's study (2011) on the regulation of financial planners.

2. The Consumer Financial Protection Bureau, created by the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, regulates the offering and provision of consumer financial products or services under federal consumer financial laws. A financial product or service is defined in the act to include financial advisory services to consumers on individual financial matters, with the exception of advisory services related to securities regulated by the SEC or state securities regulators.

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