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THE COMMISSION AND THE REGULATION OF FINANCIAL PLANNERS: ASSUMING THE APPROPRIATE ROLE

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Imagine yourself as an executive producer at MGM Studios in Hollywood watching the filming of your new hit movie -- "How to Regulate Financial Planners Without Really Trying." The movie is about a group of people in Hometown, U.S.A., who, concerned about the recent proliferation of financial planners, hire three superheroes to regulate them. Two of the superheroes, Susie States and Terry Trade Association, are cast in the leading roles because of their experience and familiarity with the practices of financial planners. Their jobs are to make sure that the financial planners are qualified to advise the townspeople on their financial affairs. The third superhero, Sammy SEC, is cast in a supporting role. His duties primarily involve registering the financial planners and ensuring that they make full disclosure to the townspeople.

Now imagine that the following conversation takes place between Dan, the director, and Pete, the producer.

"Hey Pete, let's change the plot so that the financial planners reproduce themselves every hour. Then they can really terrorize the townspeople!

"Sounds like a great idea Dan, but I don't know if our superheroes can handle all those financial planners. What if a lot of them are unqualified? Maybe we should consider giving Sammy a leading role too. He could help Susie and Terry make sure that the planners are qualified."

"I don't think that's necessary Pete. Susie and Terry have been in the leading roles for a long time. They've given us no reason to believe that they can't handle the job. I'm afraid that if we put Sammy in a leading role it will just cause confusion and result in overburdensome regulation of the planners. Before we do anything drastic, let's see if there really is a problem."

"You're probably right Dan. There's no point in screwing up the plot if we don't have to. Let's go with Sammy in his original supporting role. He seems to have been effective so far. And besides, it will leave him some energy to act in his next movie -- "Brokerage at Tiffanys."

As you've probably gathered by now, the plot of this movie is not totally fictitious. Financial planners currently are subject to regulation on both the federal and state level. Some also belong to -- and voluntarily comply with the requirements of -- professional trade organizations. And, just as in our movie, the states and the trade organizations have assumed the leading roles, while the Commission traditionally has played more of a supporting role. Explosive growth in the number of financial planners over the past five years, however, has called into question the adequacy of the regulatory scheme. It has brought forth cries for additional regulation, mostly in the way of minimum qualification and financial responsibility standards for financial planners.

If additional regulation is indeed the way to go -- a conclusion that I do not necessarily accept -- what should the Commission's role be? Should the Commission assume a leading role and seek legislation empowering it to impose minimum standards directly or indirectly through a self-regulatory organization? Or should the Commission instead retain its current supporting role, leaving the leading roles to the states and the trade organizations?

What I'd like to do today is to explore with you the answers to these questions. As the self-appointed director of this movie, I will attempt to convince you -- the executive producer -- that the appropriate role for the Commission in the regulation of financial planners, at least for the present, is a supporting one. In pursuit of this goal, I'll ask you to please bear with me while we examine the current regulatory environment for financial planners. I think this will enable you to make a well-informed decision as to what the appropriate role for the Commission should be.

I.

In examining the regulatory environment, let's start with the leading roles of the states and the trade organizations. First, the states. In many states, financial planners are deemed to be investment advisers and are regulated as such. Currently, thirty-seven states, including New York and California, regulate investment advisers in one form or another. There are substantial variations, however, in the nature and extent of regulation. For example, while all of these states require registration of investment advisers, only about a third require agents of investment advisers to register. Similarly, although many have extensive examination requirements, others have none. Finally, while many have financial responsibility requirements, the tests are different in almost every state.

In an attempt to address the lack of uniformity among the states, the North American Securities Administrators Association (NASAA) Committee on Investment Advisers is working to develop a uniform approach to adviser regulation. The Adviser Committee has organized an Industry Advisory Group to assist them in this regard. They contemplate a uniform registration form, based on the Commission's registration form for investment advisers, Form ADV, and uniform qualification and examination requirements. Recently, NASAA appointed a high level committee under former NASAA President Mike Unger to specifically address the question of appropriate financial planner regulation. In its supporting role, the Commission's Division of Investment Management is working closely with the NASAA Committees.

In addition to regulation by the states, many financial planners also are subject to the requirements of the professional trade organizations which they choose to join. The two most widely recognized organizations are the International Association for Financial Planning and the Institute of Certified Financial Planners. Like the states, these organizations hope to play a leading role in regulating financial planners. As such, they have taken a great interest in fostering higher standards for financial planners through examination and experience requirements. For example, membership in the ICFP is limited to "certified financial planners" and CFP candidates while the IAFP has established a Registry of Financial Planning Practitioners. It appears that the primary goal of organizations such as the IAFP and ICFP is to provide a form of licensing for financial planners, thereby promoting public recognition of financial planning as a profession.

II.

Now that we've examined the leading roles of the states and the trade organizations, let's look at the Commission's supporting role. Basically, it involves administration of the Investment Advisers Act of 1940. A 1981 Commission interpretive release concerning applicability of the Advisers Act to financial planners 1/ concluded that most financial planners are investment advisers within the meaning of the Act and, thus, are subject to the Act's requirements. In short, a financial planner falls within the definition of "investment adviser" if he or she is in the business of providing advice concerning securities -- whether specific or not -- for compensation. Before we get into what the Act requires, however, I think it will be useful for us to briefly review the legislative history of the Act.

For more than twenty years, the Advisers Act was little more than a continuing census of investment advisers. It required registration of most investment advisers and prohibited registered investment advisers from engaging in fraud, entering into performance fee arrangements and assigning investment advisory contracts without the client's consent. Nonetheless, it was thought to be inadequate in many respects. The bases for denial or revocation of registration were very narrow and limited. This made it possible for persons who, for example, had been convicted of securities fraud, to engage in the investment advisory business. Also, the Commission had no authority to inspect an investment adviser's books and records, or even to require investment advisers to maintain books and records. Finally, the Act only prohibited fraud by registered investment advisers and gave the Commission no power to adopt rules defining fraudulent acts and practices.

1/ *See* Investment Advisers Act Release No. 770, August 13, 1981.

The 1960 Amendments to the Advisers Act, in a manner of speaking, gave some "teeth" to the statute. Among other things, the amendments: (1) expanded the grounds for disqualification; (2) authorized the Commission to require the keeping of books and records and the filing of reports; (3) authorized the Commission to inspect investment advisers; and (4) amended the Act to proscribe fraud by investment advisers exempt from registration. The Act was again amended in the Investment Company Amendments Act of 1970 and the Securities Act Amendments of 1975. Although these amendments were intended to make the regulatory scheme for investment advisers similar to that for broker-dealers, a major difference was the absence of any examination requirements or financial responsibility provisions for investment advisers.

In 1976 the Commission supported legislation which would have empowered the Commission to prescribe standards of minimum professional qualifications and financial responsibility for investment advisers. In reporting favorably on the bill, the Senate Committee on Banking, Housing and Urban Affairs stated:

> The growth of the investment advisory industry in recent years . . . raise[s] serious questions as to the adequacy of the Advisers Act to accomplish its original objectives [of assuring] the protection of investors and prevent[ing] adverse effects on the securities markets. 2/

In a separate statement of minority views, however, Senator Jake Garn retorted:

> The sponsors of [this] bill use as their justification . . . the fact that the number of investment advisers registered with the . . . Commission has increased [dramatically]. They further [admit that] "this legislation is not predicated on the industry's failures or shortcomings." The arguments attempting to demonstrate a need for the legislation are clearly inadequate. 3/

Also in a statement of minority views, Senator Jesse Helms stated:

> [The] hearings into this matter uncovered no compelling need or evidence that examination and licensing [of investment advisers] is necessary at this time or at any other time. 4/

2/ S. Rep. No. 910, 94th Cong., 2d Sess. (1976) 2.

3/ *Id.* at 23.

4/ *Id.* at 18.

Senator Helms went on to state:

> It seems to me that if people really need to be protected against themselves, disclosure would amply accomplish this goal . . . I see no compelling need to prevent people from receiving their investment advice from an astrologer, so long as they know the source of their advice. 5/

The legislation was never voted on by the full Senate and, needless to say, died. However, as I will explain in a moment, the Commission embraced Senator Helms' approach by adopting the so-called "brochure rule" in 1979.

Now that we've familiarized ourselves with the legislative history, let's turn to the requirements of the Advisers Act. As we have already seen, the Act imposes a number of affirmative and negative obligations on investment advisers. Because much of the remainder of this conference will be devoted to an in-depth examination of the Act's requirements, I won't upstage my colleagues by attempting to cover all the requirements in detail. I would, however, like to expand a bit on the antifraud provisions.

In SEC v. Capital Gains Research Bureau, the Supreme Court declared that an investment adviser is a fiduciary who owes his client "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts'." 6/ The Court went on to state that "[f]ailure to disclose material facts must be deemed fraud or deceit . . ." 7/ Thus, the duty of a financial planner who is an investment adviser includes an obligation to disclose all material facts -- including actual and potential conflicts of interest -- to his clients where failure to do so would operate as a fraud or deceit.

In addition to the statutory prohibition against fraud, the Commission has adopted a number of rules under the antifraud provisions. One rule, Rule 206(4)-1, places limitations on advertising by investment advisers. Another rule, Rule 206(4)-2, prescribes certain procedures to be followed in connection with custody or possession of client funds or securities. Perhaps the most important rule from the standpoint of regulating financial planners, however, is Rule 204-3, the so-called "brochure rule." As I alluded to earlier,

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5/ Id. at 20.

6/ SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963).

7/ Id. at 200.

the brochure rule was an outgrowth of and, in effect, a substitute for the 1976 legislation which died in committee. In proposing the rule for comment in 1975, the Commission stated:

> It is expected that required disclosure of . . . qualifications [of advisory personnel] will enable customers to compare the qualifications of different advisers and will result in efforts by investment advisers to maintain at a high level the competence and qualifications of the persons they employ. 8/

The rule, adopted in 1979, basically requires investment advisers, with certain exceptions, to deliver to every client or prospective client a written disclosure statement concerning their background and business practices. Thereafter, on an annual basis, the adviser must offer in writing to deliver a current disclosure statement to the client on request without charge.

In terms of specific disclosure requirements, the rule requires investment advisers, among other things, to disclose: (1) the nature of the services generally offered by the investment adviser and the fees for such services, as well as other business activities of the adviser; (2) general standards of education and business background, if any, established by the adviser with respect to associated persons; and (3) the name, age, formal education after high school and business background for the preceding five years of each member of the adviser's investment committee or similar body.

Aside from these specific disclosure requirements, the brochure rule also requires that the disclosure statement include: (1) an audited balance sheet for investment advisers that hold customer funds and securities or who require prepayment of advisory fees; and (2) a disclaimer to the effect that the Commission has not passed on or approved the qualifications or business practices of the investment adviser.

III.

Now that we have a feel for the regulatory environment applied to financial planners, I think we're better equipped to make a well-informed decision as to the appropriate role for the Commission. So let's begin our analysis. As I indicated at the outset of my remarks, I will attempt to convince you that the appropriate role for the Commission in the regulation of investment advisers, including financial planners, is a supporting one.

8/ See Investment Advisers Act Release No. 441, March 4, 1975.

In this regard, I think we should ask ourselves two questions. First, has the Commission been effective in its supporting role? Second, if so, would the Commission be more effective in a leading role?

With respect to the first question, I think the answer is yes. As we have seen, financial planners are subject to a comprehensive set of registration, disclosure and other requirements under the Advisers Act. The statutory disqualification provisions -- the so-called "bad boy provisions" -- permit the Commission to censure, suspend, or revoke the registration of an adviser upon a finding that it is in the public interest and the person has engaged in conduct violating the securities laws or has been convicted of certain specific crimes. In addition, advisers must maintain books and records, file reports and submit to inspections. They are subject to limitations concerning performance fee arrangements, assignment of advisory contracts and use of the term "investment counsel."

Most importantly, however, financial planners are fiduciaries under the antifraud provisions and, as such, must make full and fair disclosure to their clients. The specific antifraud rules -- particularly the brochure rule -- facilitate this disclosure and help to ensure that clients and prospective clients are well informed as to the qualifications and business practices of advisers.

As you probably have gathered by now, I am a firm believer in the disclosure approach. This is because it avoids excessive government regulation and intrusion into areas traditionally relegated to the states. At the same time, however, it is one of the most effective ways of protecting investors. It has worked extremely well under the 1933 and 1934 Acts, and I think it can be just as useful in protecting investors under the Advisers Act. As John Casey, then Chairman of the Investment Counsel Association of America, told the Senate Committee in 1976:

> One point on qualification is that investing is certainly not a precise science, and that the disclosure route of qualifications may well be better than prescribing that somebody have a background in fundamental analysis. 9/

For example, by mandating disclosure of the background and business practices of financial planners, the brochure rule, in effect, helps to impose "market discipline" on those financial planners that may not be as qualified as others. I hesitate to use the term "unqualified" financial

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9/ S. Rep. No. 910, 94th Cong., 2d Sess. (1976) 18.

planner, because I'm not even sure what it means. With full and fair disclosure of the planner's qualifications, however, I am confident that a reasonable investor can determine for him or herself whether a particular planner is "qualified."

Of course I realize that regulations are only as good as the people who administer them. In that respect, I'd like to stress that the Commission is deeply concerned that financial planners are sufficiently aware of -- and are complying with -- the requirements of the Advisers Act.

With respect to the registration requirement, there appears to be a misconception that most financial planners have chosen to disregard this requirement. I've heard it said that while the estimated number of financial planners is anywhere from 50,000 to 200,000, there are only 8,000 registered investment advisers. This disparity can be explained, in part, by the fact that the Act does not require agents of investment advisers to register individually. Because many financial planners are affiliated with large money management firms or other financial institutions -- such as banks and brokerage houses -- they are not required to register individually. As a result, estimates of the number of unregistered financial planners may be vastly exaggerated.

In terms of ensuring compliance with the registration requirement, the Commission, as I indicated earlier, issued an interpretive release in 1981 concerning application of the Advisers Act to financial planners. The release seems to have had a positive effect because the Division has been receiving over 200 registration applications a month, many of which are from financial planners. In addition, the Division is actively engaged in developing methods of identifying unregistered investment advisers and reminding them of their obligations under the Advisers Act.

Aside from the registration requirement, the Division periodically conducts inspections of investment advisers to ensure compliance with the provisions of the Act. Among other things, the staff examines the disclosure documents under the brochure rule to make sure they are accurate.

Where violations of the Act come to the staff's attention, they are investigated thoroughly and, in appropriate cases, actions are brought by the Commission. Since July of 1983, the Commission has instituted over twenty injunctive actions and administrative proceedings against investment advisers where the allegations included violations of the antifraud provisions of the Advisers Act.

Just this month, in fact, the Commission brought an administrative proceeding against a registered investment adviser, Janis & Associates, and its president, Bettie Janis. Among other things, the Enforcement Division alleged that

Janis made misrepresentations to her clients concerning the nature of her education, her business and professional background, and her net worth. Apparently, she told clients at the time of their initial consultation that she had a B.A. in accounting, was at one time a practicing C.P.A., and had a net worth of nine million dollars. In fact, none of these representations were true. In instituting the action, the Commission simultaneously determined to accept the defendants' offer of settlement wherein the registration of Janis & Associates was revoked, and Janis & Associates and Janis were barred from association with any investment adviser, investment company or municipal securities broker or dealer.

In addition to administering the Advisers Act, the Commission, in its supporting role, is working closely with NASAA to make state investment adviser regulation uniform, and is monitoring the activities of the trade associations.

Having concluded that the Commission has been effective in its supporting role, would the Commission be more effective in a leading role? I think not. In this regard, it is important to remember that substantive regulation and licensing of professions -- such as the legal and medical professions -- traditionally has been left to the states. This is as it should be. Just as was the case in our fictitious movie, the states and professional organizations are much more familiar with the practices of the members of these professions than the federal government, and are much more able to devise appropriate qualification standards. I think this is true for investment advisers, particularly financial planners, which are the most heterogeneous group of people regulated by the Commission.

For example, some financial planners are "generalists." As such, they might have a broad knowledge of law, accounting, taxes, insurance, retirement programs and securities, enabling them to develop a comprehensive financial plan for a client. Other financial planners might be "specialists," emphasizing only one or two of these areas. In terms of compensation, some financial planners receive fees while others receive commissions. Finally, a financial planner may be affiliated with a large money management firm or financial institution -- such as a bank or a brokerage house -- or may be independent. Interestingly, many of the independent financial planners registering with the Commission also are agents of broker-dealers.

In determining whether the Commission would be more effective in a leading role, it is also important to bear in mind that Congress always has been reluctant to substitute federal authority for state regulation -- particularly where there is no compelling need to do so. The regulation of financial planners is a perfect example of this.

As you recall, in 1976 the Congress declined to adopt legislation which would have empowered the Commission to impose minimum professional qualifications or financial responsibility standards on advisers. In my view, this legislation died primarily for two reasons. First, as Senator Jesse Helms noted, there was no evidence presented by the Commission or anyone else demonstrating a need for federal examination or licensing of advisers. There were no statistics, no surveys, no file of "horror stories." Second, there was no demonstration that the states' or the industry's efforts in regulating advisers were insufficient or inadequate. In short, a substantial increase in the number of advisers alone was not considered adequate justification for such a severe intrusion into an area traditionally relegated to the states.

I think the reasons for rejecting any such legislation are even more compelling today. Just as in 1976, it seems that the sole justification for federal intervention is the recent dramatic growth in the number of financial planners. No statistics, surveys or "horror stories" have been presented -- just bare assertions that the investing public will be exposed to so-called "unqualified" financial planners.

In addition, there has been no demonstration that the current regulatory environment is inadequate. In fact, the evidence is to the contrary. In this regard, it is interesting to note that in 1973 an Advisory Committee on Investment Management Services for Individual Investors recommended that the Commission request legislation involving professional qualifications and financial responsibility standards for investment advisers. 10/ This recommendation was based, in large part, on the fact that most states had no such requirements and that the Advisers Act only required disclosure of education and experience on Form ADV and did not require that it be provided to the client.

As we have seen, the situation is different today. Numerous states have registration, examination and financial responsibility requirements. Moreover, trade organizations, such as the IAFP and ICFP, also hope to take a leading role in establishing qualification standards. And finally, the brochure rule, adopted by the Commission in 1979, requires investment advisers to provide clients with a disclosure statement concerning their education and experience.

I seriously question whether empowering the Commission to prescribe minimum qualification and financial responsibility standards would benefit anyone other than established financial

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10/ *See* Report of the SEC's Advisory Committee on Investment Management Services for Individual Investors, *Small Account Investment Management Services* (January 1973).

planners. I am concerned that any type of federal licensing would somehow be viewed as a "stamp of approval" by the Commission and would result in additional -- and totally unnecessary -- barriers to entry to other members of the financial planning industry.

As far as establishing an SRO for financial planners, which would be subject to Commission oversight, I hesitate to endorse such an approach. Self-regulation for broker-dealers through the NASD and the exchanges has worked well primarily because of their commonality of interests. Because broker-dealers must deal with each other frequently, there is a great need for rules to govern their day-to-day relationships. In addition, the preferential price treatment provided to members of the NASD provided an economic incentive for joining the organization. Finally, it was the broker-dealer industry -- and not the Commission -- that was instrumental in setting up the NASD.

In sharp contrast, there is not the same type of commonality of interests among financial planners. As we have seen, the nature of the financial planning industry is extremely diverse. Financial planners do not deal with each other. Also, there would seem to be less economic incentive for financial planners to join an SRO. Finally, it appears that no consensus has developed in the industry on the desirability of an SRO. While I could support self-regulation for financial planners, I am concerned about the potential anti-competitive effects. So I would hope that the industry would be sensitive to the antitrust implications of any such organization.

Assuming that I have convinced you that the Commission's supporting role in the regulation of financial planners is the appropriate one, let's talk for a moment about what the Commission can do to make its role even more effective. Of course, the Commission should continue in its efforts to ensure that financial planners are aware of -- and are complying with -- the provisions of the Advisers Act.

In addition, the Commission should continue to review its disclosure regulations applicable to financial planners and adjust them where necessary. One area that warrants particular attention is the disclosure required under the brochure rule concerning the education and experience of advisory personnel. It is critical that these requirements be continually updated -- and perhaps even expanded where necessary -- to ensure that clients are receiving full and fair disclosure. For example, in light of the growing concern about financial planners, it has been suggested that the Commission reexamine whether the rule's disclosure requirements concerning education and experience should cover all personnel giving investment advice -- rather than only those making policy. And maybe it would be a good idea to require that the disclaimer mandated by the brochure rule be highlighted on the front page of the disclosure document -- sort of like the legend that must be included on restricted stock.

At the state level, the Commission should continue to work with the NASAA Committees in developing a uniform approach to adviser regulation. Our efforts with NASAA to develop a uniform ADV Form provides an opportunity to improve the form, particularly so it will elicit pertinent information about financial planners. And finally, the Commission should continue to monitor the activities of the professional trade organizations to make sure that standards set by them -- or by any national organization that might be formed -- are not erecting unreasonable barriers to entry or otherwise restricting competition for the industry.

CONCLUSION

In closing, I'd like to say that effective regulation does not depend on how many regulators are cast in leading roles but, rather, on whether regulators are cast in the appropriate roles. It seems to me that -- at least in the case of financial planners -- a supporting role is the appropriate one for the Commission. The states and the trade organizations have done a fine job so far in their leading roles. They have demonstrated a willingness to deal with the difficult regulatory problems presented and -- barring unforeseen circumstances -- I see no reason for the Commission to assume a leading role. And remember -- Academy Awards are given for supporting as well as leading roles.