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News Release

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The Financial Planner: A Perspective for the Future

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The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

The Financial Planner: A Perspective For The Future 1/

The organizers of this conference, and you, the participants, are to be congratulated for recognizing and trying to meet the many challenges facing your profession. With an eye on these challenges, your leaders have provided you with a wide ranging program on the latest financial planning techniques. In my remarks, I will try to echo their theme of challenge but will focus on regulatory issues and recent developments of importance to you and your industry.

As you are aware, the financial planning industry has grown dramatically in recent years. Current estimates of the number of financial planners nationwide range from 250,000 to 350,000. Some even put the number at 400,000. 2/ It is my impression that this expansion is being fueled by the increasing complexity of the financial services industry and the consequent demand by the public investor for assistance in dealing with this complexity. The number of investment alternatives is greater than ever before and still growing. In fact, the very breadth of available choice may generate as much confusion as it does opportunity. Not long ago, investors were limited to selecting among real estate, passbook savings or a narrow range of stocks and bonds as investment alternatives. Today, the choice is not so simple.

1/ These remarks were prepared by Commissioner Peters with the assistance of Andrew Feldman, Counsel to the Commissioner.

2/ See Geltner, Looking for Abuse, Financial Services Times, Jan. 1987, at 3.

We must contend with new vehicles such as IRAs, money market funds, and index options and futures not to mention LYONs, TIGRs and CATS, which makes one question whether Wall Street has become more of a game preserve than a financial market. It is no wonder that investors increasingly seek professional assistance in devising investment strategies. As financial planners, you are frequently among the first consulted. That probably explains the financial planning industry's explosive growth.

The media has chronicled the growth of your industry and, through its reporting, has highlighted alleged abuses engaged in by some who represent themselves as financial planners. It is probably fair to say that, in part, it is the media's coverage of your industry and its problems that has made you an object of attention for Congress and state and federal regulators. We have had to focus on a number of issues, including who or what is a financial planner, what abuses actual or perceived are prevalent in this largely unregulated area and what, if any, regulation should be imposed. What has been the result of this attention?

- In June 1986, Congress held hearings on investment advisers and financial planners, during which investors, industry associations, and regulators testified. Congress concluded that unscrupulous investment advisers and financial planners could cause considerable harm to investors and consequently instructed the SEC to conduct a comprehensive study of the current status of the industry and the degree to which abuses occur.

- The SEC has begun that study, and is analyzing topics touching on all aspects of financial planners and the financial planning process. This is an important assignment coming as it does at a time when the entire financial services industry is experiencing incredible growth and fundamental change. You may expect that the ICFP will be invited to assist the Commission in this task.
- The NASD has established a pilot program to explore the possibility of the NASD's serving as a self-regulatory organization for investment advisers. The NASD's pilot, which is being coordinated with the SEC's study, applies only to NASD member broker-dealers and their associated persons who are registered investment advisers. This project should be of interest to you because the term investment adviser is defined broadly enough to cover financial planners, if you offer any advice with respect to securities.
- NASAA already has progressed beyond the study stage, and has proposed model legislation which, as I will discuss more fully later, would bring your industry under more comprehensive state regulatory oversight, if adopted by its member states.

The spotlight directed upon you is healthy for the financial planning industry as a whole. While the glare may cast unflattering shadows, it nevertheless provides a useful focal point for considering the issues I previously raised: (1) what is a financial

planner; (2) what abuses need to be addressed; and (3) what regulation, if any, is needed for the industry. Moreover, a by-product of the scrutiny may be that those who affect the title are made aware of their duties and responsibilities whereas they may otherwise view certification as nothing more than a union card providing them a ticket to the newest money game in town.

With regard to the first issue, the appropriate response to the question of what or who is a financial planner is probably "who knows". The deregulation of the financial services industry has made it easier for bankers, insurance agents, accountants and estate planners, as well as stock brokers and registered investment advisers, to use the title "financial planner". Therefore, it may be difficult for the public to understand what it is buying when it pays for financial planning. More significantly, it may also be difficult for the financial planner to come to terms with what he or she is selling. That may continue to be the case until we come up with a universally accepted definition of "financial planning".

Currently, the ICFP is working on a definition. I understand that the Institute is inclined to say that anyone who calls himself a financial planner is one. The International Association of Financial Planners ("IAFP") defines a financial planner as any person who for compensation: (a) provides a person with a written plan recommending strategies to achieve overall financial goals;

and (b) performs such services for fifteen or more persons during a year. NASAA includes financial planners in its definition of investment advisers. 3/

The lack of a universally accepted definition and the fact that anyone from a stock broker to an insurance agent may claim the title, emphasizes, I think, the appropriateness of my "who knows" response. Regardless of who qualifies to claim the title, it is clear that the changing structure of the financial services industry and the resulting increased competition will further blur the lines between financial planners, investment advisers, and registered representatives. These outwardly different professions currently are subjected to different forms of regulation or, in the case of financial planners, little regulation at all. This will change. With more people seeking assistance with the process of developing a road map for achieving their financial goals, more investment advisers and registered representatives are calling themselves financial planners. The overlap between advisers and brokers on the one hand, and between the two and planners on the other, will only continue to increase.

As a matter of fact, the likelihood is that the activities of most financial planners fall within the definition of investment adviser under the federal securities laws, and thereby subject the

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3/ Already, 47% of the investment advisers registered with the SEC are either registered as broker-dealers (17%) or are affiliated with registered (broker-dealers (30%)).

planner to the legal and regulatory requirements attendant to that status. The Investment Advisers Act of 1940 ("Advisers Act") defines the term "investment adviser" to include "any person who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." 4/ Every securities law definition naturally has its exemptions, and the definition of investment adviser is no exception. However, the exemptions are crafted very narrowly, mostly to exclude professionals who offer investment advice incidental to other services -- but financial planning is not one.

It is important to understand that the Advisers Act requires essentially all who render investment advisory services to register, whether they call themselves investment advisers or not. 5/ In fact, it has been estimated that at least 95% of all financial planners should be registered with the Commission as investment advisers. 6/ Frankly, the agenda for this meeting indicates that this generalization could certainly apply to the membership of

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4/ See Section 202(a)(11) of the Advisers Act. See also, Investment Advisers Act Release No. 770 (Aug. 13, 1981), 46 FR 41771.

5/ Section 202(a)(11)(D) of the Advisers Act, however, exempts from registration any bona fide newspaper or financial publication of general and regular circulation. The United States Supreme Court has held that this exemption includes those investment advisers who only provide impersonal investment advice through newsletters and other media. See Lowe v. Securities and Exchange Commission, 472 U.S. 181 (1985).

6/ See Ferrara & Crespi, Developments in the Regulation of Financial Planners, in R. Ferrara, Regulation of Financial Planners in the 1980s 9, 21 (1986).

the ICFP. I note that the scheduled panels cover a variety of significant current topics, including international investment opportunities, a secondary market for limited partnership interests, and advice on negotiating the mutual fund maze. If you do not make recommendations with respect to investing in securities as part of your businesses, then your program chairman has badly missed the mark.

I hesitate to make my point too vigorously, for fear of causing a landslide of 300,000 applications for registration into the SEC. Nevertheless, I will briefly review what compliance with the Advisers Act entails. The Advisers Act provides a system of mandatory registration and or regulation designed to provide investors with basic facts about the background of each adviser. 7/ The Act, however, does not require advisers to meet any competency, education, or experience requirements. Registered advisers are also required to provide a brochure containing essential current information about themselves and their business to prospective clients and to at least those current clients who request one. 8/ Moreover, under the Act's broad antifraud rules, advisers, whether or not registered, at a minimum, must disclose all actual and potential conflicts of interest. 9/

7/ But see supra note 5.

8/ See Rule 204-3 under the Advisers Act, 17 CFR Part 275. 204-3.

9/ See Section 206 of the Advisers Act, 15 U.S.C. 80b-6. See also infra text accompanying notes 13-15.

The mention of conflicts of interest brings me back to the second issue I identified as being the subject of current scrutiny. Widespread rumors of abuse in your profession, illustrated by documented reports of a massive fraud like First Meridian Planning Corporation, 10/ highlight the care with which you must approach your duties if the profession is to continue to enjoy an environment of relatively minimal regulatory restraint. A rising crescendo of criticism and an ultimate crack down by regulators otherwise may be the result.

You may well ask: what conflict of interest? All I do is sell financial plans. I dare say that there are few of you that are able to give such a righteous response. A couple of recent unscientific studies report that very few, if any, planners offer planning services only. These studies suggest that for most planners, even those who charge a relatively high planning fee, planning is at best a break-even proposition. The service is offered in many cases to attract clients for the real moneymaking business of selling products. At least for the middle income consumer, much of what is offered in the name of planning is really just a sales pitch for products which, if the client is lucky, will be tailored toward his general financial situation, his goals and his risk tolerance. 11/

10/ See Siconolfi, New York Financial Planning Firm Is Charged With Defrauding Investors, Wall Street Journal, Nov. 6, 1986, at 7.

11/ See Looking for Mr. Good Plan, Consumer Reports, Jan. 1986, at 39; Geltner, supra note 2.

It is important to remember that financial planners who give investment advice have a wide range of disclosure obligations under both state and federal law. Moreover, their role as fiduciaries heightens their disclosure obligations. The significance of this duty has been recognized widely by state courts and, for advisers subject to federal regulation, by no lesser authority than the United States Supreme Court. The Supreme Court has held that investment advisers who fail to disclose material facts to clients violate their fiduciary duties and thereby commit fraud. 12/ I think that it bears repeating that these obligations arise from your conduct and do not result from the fact of registration. Registered or not, you have a duty of disclosure.

Conflicts of interest are frequently deemed material facts. In our current free-wheeling, deregulatory environment, one tends to lose sight of that. A particularly ticklish area is the proper disclosure that should accompany recommendations of investment vehicles that are coupled with sales incentives. The press has seized upon this area, and has reported widely on the fact that an adviser might be able to earn a fabulous sports car or a trip to an exotic resort by being the one to sell the most of a particular product. 13/ There also are more

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12/ See Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

13/ See Rose, Incentives vs. Clients: Which Ones Most Concern Financial Planners?, Wall Street Journal, Nov. 24, 1986, at 33.

subtle potential problems, such as when an adviser recommends a product in which the adviser has some financial interest. The law clearly requires that you disclose any such potential conflicts of interest to your clients. The registration form that investment advisers must file with the Commission requires the disclosure of any interest in client transactions and, at a minimum, such disclosures also should be made in the brochures advisers provide to their clients. 14/

Given the broad scope of the Advisers Act's antifraud provisions, the responsibility that investment advisers have to disclose conflicts of interest transcends the simple requirements of the brochure rule. Investment adviser brochures are not necessarily the best vehicle for this type of disclosure. Clients are not particularly well-served where disclosure of product-related compensation is buried deep within the brochure. Moreover, the information may not reach existing clients to whom a brochure is provided only upon request. As fiduciaries, advisers have an obligation to inform their clients of any potential conflicts of interest whenever they arise. Having said that, I would note that the Commission, through rigorous enforcement of the 1940 Act disclosure requirements, is not taking a position on whether it is proper for a financial planner

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14/ See Investment Advisers Act Form ADV, Item 21, 17 CFR Part 279.1.

to wear two hats. In fact, I think a poll of the present Commission would disclose no reservation on this point. It is a disclosure issue pure and simple.

Since the advertisement for my remarks suggested I would offer a perspective for the future, I had better attempt to do so in the few minutes remaining. I shall attempt no predictions since they are certain to fail, particularly when made on Friday the 13th. Therefore, I will limit myself to observations. My first observation is that since the future of financial planners is interwined with that of others rendering related financial services, planners should expect to become increasingly subject to a variety of financial services regulatory initiatives. The SEC, the NASD, and NASAA projects I mentioned earlier are worthy of your attention. NASAA's efforts already have yielded concrete results. As you may know, 39 states and Puerto Rico and Guam in some way regulate investment advisers. NASAA proposes that these jurisdictions and the 11 states that have yet to act in this area adopt a uniform set of laws. NASAA's model legislation would adopt the approach that the SEC has followed and include in the definition of "investment adviser" a person who calls himself or herself a financial planner and gives investment advice.

The model legislation also would provide state securities administrators with the authority to adopt rules governing investment advisers, including a rule to require that advisers provide customers with brochures containing specific information, as does

the SEC. The model code, however, would go beyond the scope of federal regulation in two significant respects. The first is that it would require individual employees as well as the investment advisory firm to register with the state. The second is that the state securities administrator would have the authority to require that advisory employees pass a competence test or meet other qualification requirements in order to do business. 15/

The future of NASAA's proposal has a significant impact on the role the SEC will or will not play in regulating your industry. In anticipation of this more assertive state regulatory posture, the SEC is contemplating turning oversight of small investment advisers over to the states. The SEC has preliminarily discussed these proposals with NASAA and has found the initial reception generally favorable. 16/ Under one proposal, advisers with fewer than 100 clients and under $1 million in client assets under management would be exempted from federal registration if they were registered in all of the states where they do business. Under a second proposal, advisers functioning solely in one state with fewer than 200 clients and $10 million under management would be regulated solely by the state where they do business.

15/ See Geltner, NASAA To Offer Uniform IA Amendment To States, Financial Services Times, Dec. 1986, at 3.

16/ NASAA will provide the Commission with a formal report on the proposals at the 1987 Conference on Federal-State Securities Regulation which will be held on April 7 and 8, 1987, in Baltimore, Maryland.

Pending some definitive action on the initiative to have all states adopt laws regulating the investment adviser/ financial planner industry, most of you will have to deal with the SEC. Therefore, your prospects for the future may include two SEC initiatives that I would like to mention for you. As warranted by the current focus of federal investment adviser regulation, these initiatives emphasize disclosure.

The Commission has proposed Rule 206(4)-4, to be adopted under the Act's general antifraud provisions, which would codify an investment adviser's existing fiduciary obligations to disclose material financial and disciplinary information to clients. Note that I referred to investment advisers generally -- the proposal, like the general antifraud provisions, applies to both registered _and_ unregistered investment advisers. Briefly summarized, the Rule would require advisers to disclose all material information about the adviser's financial condition that is reasonably likely to impair the ability of the adviser to meet contractual obligations to clients. The adviser would also be required to disclose any legal or disciplinary event important to evaluating the adviser's integrity. The proposed Rule specifies certain disciplinary events, occurring within the past ten years and involving the adviser or key personnel, which would have to be disclosed. 17/

17/ _See_ Investment Advisers Act Release No. 1035 (Sept. 19, 1986), 51 FR 34232.

The SEC has received 29 comment letters on proposed Rule 206(4)-4. Most commentators generally endorsed the objectives of the proposed rule but nevertheless were critical of its specific provisions. For example, the Investment Company Institute and a number of commentators suggested that the proposed disclosures should be integrated in the brochure advisers provide to their clients as well as be made a separate disclosure requirement under the Advisers Act's general antifraud provision. The American Bar Association stated that the proposed rule was in some respects too vague and in other respects too broad in its coverage, and asserted that there was no demonstrated need for the disclosures which the proposed rule would provide.

The SEC is analyzing the comments received before determining whether, and in what form, to adopt the proposed rule. While I cannot purport to speak for my fellow Commissioners, I would like to give you my preliminary thoughts on the subject. Like most commentators, I believe that the disclosures the Rule would require would be valuable to investors. I also believe that supplemental brochure disclosures might be an idea worth considering. Nevertheless, requiring the proposed disclosures under the brochure rule alone would not be a satisfactory substitute for the proposal. A couple of reasons come immediately to mind. The first is that only registered investment advisers are subject to the brochure rule. The second is that those advisers who are subject to the Rule are <u>required</u> to provide brochures to prospective clients only but they need only offer the brochure to existing clients and provide it upon request.

I do agree, however, that the proposed rule needs some fine tuning -- so that its requirements are clearly and succinctly stated.

Having said that, I would like to respond to those commentators who would require us to demonstrate the necessity for the Rule and point out that the Rule 206(4)-4 rulemaking does not readily lend itself to a cost-benefit analysis. The reasons are simple. It is easy to envision why disclosing adverse information about oneself to ones' clients could very well have significant costs, and it is hard to imagine how one would be benefitted by making those disclosures. At the same time, it is difficult to quantify the benefits that investors might derive from knowing about their advisers' disciplinary history or financial trouble because it is hard to measure the potential injury from trouble you have avoided. General notions of fairness and equity, and the probability of avoiding future losses from fraud, regrettably do not have a place in the cost-benefit calculus.

The expansion of the financial planning and investment adviser industries has had the salutary effect of providing a greater diversity of services at more competitive prices to a broader group of consumers. However, this growth raises the possibility, thought by some to be a probability, of increased fraud and abuse. Because of this specter, Congress, federal and state regulators are reevaluating the regulatory structure. I cannot predict the outcome of that process, but I hope that we regulators will have your support and assistance in our efforts to devise a solution that will maximize the benefits for your industry and the investing public while imposing the least possible regulatory restraint.