

## **Paving the way: Court ruling and new standards a good start for consumers—but only the beginning**

by Nancy Opiela

“We’re looking at a new world slowly opening up for consumers. They’ll be more empowered to ask the right questions about financial advice and understand what they are getting in terms of cost and value,” says Karen P. Schaeffer, CFP®, chair of the CFP Board’s board of directors.

Yes, change is on the horizon. First, there’s the overturning by a federal appeals court of the Securities and Exchange Commission’s Rule 202, nicknamed the Merrill Lynch rule, which since 1999 had allowed registered reps to offer fee-based brokerage accounts while treating investment advice as “incidental.” Second, there’s the newly revised Standards of Professional Conduct from the board of directors of the Certified Financial Planner Board of Standards that will require a CFP professional to “at all times place the interest of the client ahead of his or her own” rather than practice according to the lower current standard of “reasonable and prudent professional judgment.” Additionally, CFP professionals who provide financial planning services will have to do so with the duty of care of a “fiduciary,” a term partly defined as acting “in the best interest of the client.”

Depending on who you are, it’ll either be business as usual or a new business model. But as Schaeffer points out, as financial advisors examine their profession amid these changes, it’s worth reflecting on a key question: What will the court decision and revised ethical standards mean for consumers of financial advice? Are these new developments enough to sharpen what has, in the last decade, become a blurry distinction between brokers and financial advisors, between product sales and unbiased advice?

“Historically, the CFP Board has been at the end of the client relationship,” explains Schaeffer. “We’ve had this rigorous disciplinary process and only when the clients and the planners disagreed would we start asking the consumer, ‘What were your expectations? What was disclosed to you?’ In upgrading our standards, we’ve refocused our attention on the initial phase of the relationship so clients and planners are clear from the outset what to expect.”

James A. Barnash, CFP®, of Ameriprise Financial in Northbrook, Illinois, sees the CFP Board’s new ethics and the Financial Planning Association’s recent court victory, combining with an increasingly competitive professional environment and demographic changes that have more baby boomers looking for financial advice, providing a “window of opportunity for financial planning to take a big step forward for the benefit of the consumer.”

Explains Barnash, “My guess is that 90 percent of the financial services industry, including wirehouses, insurance organizations, large financial services institutions, and banks, are all doing assets under management and calling it financial planning. Some simply pass off pie charts and retirement calculations as financial planning. The public is confused and the time to clear up everything is now, especially as baby boomers are moving toward retirement with no time to make the do-it-yourself mistakes they made in the 1990s.”

Capitalizing on the window of opportunity Barnash sees resulting from this confluence of change depends, he says, on whether the Financial Planning Association, along with consumer advocate organizations, can continue to get their message out to the public about what constitutes financial planning advice and its value.

Industry consultant Bert Schaeffer, of VERUS Advisors, a fiduciary consulting firm in Galloway Township, New Jersey, and co-founder of the Foundation for Fiduciary Studies, agrees. He says that while the striking of the Merrill Lynch rule was a good thing, the real worth of the court’s decision will be determined to the extent the ruling can serve as the foundation to promote some “broader-based consumer education to communicate the difference between what you can expect when you go to a broker versus what you expect in terms of standard of

care from a registered investment adviser. Yet with everyone in the industry still calling themselves financial advisors, that creates confusion that likely will be difficult to overcome.”

Most consumers have no knowledge of the court ruling or revised ethics, agrees Barnash. “The most astute may know something happened, but they are not sure what or how it affects them. Certainly anyone who has a fee-based brokerage account understands that if their account doesn’t change back to a transactional brokerage account, they’ll have to sign new paperwork for an investment advisor relationship; but 99.5 percent have no clue that anything has changed.”

## Roots of Consumers’ Confusion

In fact, industry studies confirm that, even in advance of these changes, there was plenty of confusion to clear up. For example, according to an April 2007 Opinion Research Corporation (ORC) survey released by the Zero Alpha Group (ZAG) and the Consumer Federation of America (CFA), fewer than one out of three U.S. investors (30 percent) correctly understand that the “primary service” provided by stockbrokers is to buy and sell stocks, mutual funds, and bonds—not to offer investment advice. This is virtually unchanged from the 26 percent of U.S. investors who responded in the same manner in a 2004 ZAG/CFA survey.

What’s more, a majority of investors (54 percent in 2007 and 53 percent in 2004) look to stockbrokers for more than transactional assistance. Twenty-nine percent (almost identical to 28 percent in 2004) say that financial advice is the “primary” service offered by stockbrokers and 25 percent (unchanged from 2004) say advice and transaction assistance are equally important services provided by stockbrokers.

Observes Barbara Roper, director of investor protection for the Consumer Federation of America: “The current confusion is the logical outcome of letting salespeople call themselves advisors and market their services based on the advice they offer, not the products they sell. It’s the logical outcome of allowing brokers to offer extensive investment planning services without regulating those services as advice.”

Patricia Struck, past president of the North American Securities Administrators Association and Wisconsin Securities Administrator, points to advertising as a main reason for the public’s misunderstanding. “There’s a big difference in the way financial professionals used to advertise their services a decade ago and what they do today,” she says. “If you look at TV commercials and magazine ads, all financial professionals portray themselves as financial advisors. Of course investors are going to think they are getting the same thing no matter whom they go to.”

Further, Struck notes that because of the blurring of the rules and regulation of the advisor and the broker function, very often the registered reps themselves don’t fully understand the difference between the two roles. “I’ve had registered reps tell me, ‘Yes, I’m an advisor,’ yet they are not registered or regulated as an advisor. In my view, there’s a difference between *delivering* advice while the client is in the office and *following up* on the advice after the client leaves. Very few brokers do the job advisors would do—that is, regularly reviewing client accounts and making suggestions for updates.”

If financial professionals aren’t clear about what they offer, it’s easy to understand consumers’ confusion when shopping for financial advice.

A recent report, “Bridging the Trust Divide: The Financial Advisor-Client Relationship,” conducted by State Street Global Advisors and [Knowledge@Wharton](#) (an online resource that publishes research generated from Wharton School, the University of Pennsylvania’s business school), offers some perspective on how the evolution of the delivery of financial advice could be at the root of present confusion: “At one time, financial advice usually came folded into another service, sometimes in the form of suggestions from a tax accountant, more frequently in the form of stock tips offered by a broker/dealer. Often, it was good advice. At times, however, it was conflicted,

because moving particular products sometimes took precedence over doing what was right for the client.”

The report continues, “Over the last five years, that model has changed. First, advances in technology and regulatory reforms led to the rise of discount brokers, making it difficult for the old-fashioned stockbroker to sustain the same fee structure. Later, partly in response to that assault, the financial services industry looked to develop a more stable and less cyclical revenue stream. This fit in neatly with consumer concerns about conflicts of interest, and has led to a new paradigm in financial advice—the movement toward offering consultative services instead of product pushes and straightforward fee structures rather than complex or opaque ones.”

## Can Recent Changes Reduce Confusion?

Interestingly, although tying fees to advice has helped keep clients from viewing the service as a commodity, perhaps the coupling has compounded marketplace misunderstandings. That is, different advisors charge different fees and, certainly, the definition of advice varies. Consequently, it’s difficult for consumers to assess whether one firm is charging more than another for the same service.

What’s more, notes John Zhang, a marketing professor at Wharton quoted in the report, in service industries, nobody really wants to talk about price. “You want the customer to focus on the service you provide and the results that you can deliver. I think for financial advisors it’s the same,” Zhang comments.

In light of Zhang’s remarks, it’s not surprising that, according to the State Street/ Wharton study, although nearly all (95 percent) of the 366 financial advisors surveyed say they discuss fees with their clients, less than half (43 percent) of the responding 500 high net worth investors say they understand their advisor’s fee structure “completely” or “fairly well.”

Uncertainty about fees extends to ultra-high-net-worth investors as well. According to a recent Institute for Private Investors (IPI) survey, the majority of members, who are generally worth \$50 million or more, are not satisfied with the degree of transparency they get from their advisors. Although they believe the advice they receive is objective, they are concerned that they are not getting the full story about the fees they pay for the service provided.

Can the recent court decision and revised CFP ethics help change this? At a minimum, the Wharton study illuminates a possible foundation for the industry to build on while promoting recent changes. First, the study found that however consumers pay, their focus is less on the dollar amount and more on the need to understand how they are charged and what they are paying for.

That point is at the center of the Securities Industry and Financial Markets Association’s (SIFMA) objection to the overturning of Section 202. In its view, overturning the Merrill Lynch rule takes an option away from consumers, an option that clearly can be disclosed. “The court’s ruling has the potential to significantly impair an important element of consumer choice for American investors—one million investors, with nearly \$300 billion in assets, could see a significant reduction in their range of choices and options for receiving and paying for financial services,” says Mike Udoff, SIFMA’s managing director and associate general counsel.

Adds Udoff, “It’s important to remember that fee-based accounts were first introduced to better align consumer and broker interests, and these accounts have grown and served public investors well for more than a decade. Our industry provides a wide range of disclosures and documents that make clear how the different account choices operate. Over one million consumers have compared these choices and determined that fee-based accounts would best serve their needs.”

While it’s clear that the profession must do a better job of discussing fees regardless of how consumers are charged, the Wharton report also reveals that the best client/advisor relationships are based on more than simple disclosure. As the industry’s business model has evolved from pitching products to more personal counseling

and education, the process of selecting a financial advisor has become more like the process of selecting other professionals, such as a physician. Factors such as cost, sometimes even expertise, often are not the consumer's primary considerations. Rather, the report says, consumers of financial advice are looking for advisors whom they trust enough to make difficult decisions for them.

## More than Regulations and Ethics

For most consumers, however, trust—the key component of a positive, long-term business relationship—isn't born of regulations or industry ethics. Rachel Croson, professor of operations and information management at Wharton, believes consumers choose a financial professional based on the answer to one simple question: "Do I trust you not to steal money from me?"

Although the court decision and ethics provide talking points for planners to stress their expertise and ethics, regulation alone cannot inspire trust, says Croson. "Historically, the industry has tried to legislate trust through penalties for rule violations, but that has proved ineffective," she explains. "Think of the penalties we have for speeding. Speeding is a very serious safety violation, but because we all know what the penalties are, that's where our focus is. Although we start with a rule that's in everyone's best interest to uphold, the focus ends up on the fine for breaking the rule. In some cases, drivers may make a judgment on whether they can afford to get caught breaking the law."

Croson also cites a study by a Wharton colleague on parents picking up their children up at daycare. For the most part, everyone was on time. However, when a \$10 late fee was instituted for each half-hour, late pick-ups skyrocketed. "Parents simply looked at the extra \$10 as an additional cost, something they would be willing to pay for another half hour," says Croson. "As illustrated here, increased regulation doesn't always result in more people doing the right thing. Often, encouraging people to act in a particular way simply because it's the right thing to do requires something softer."

In fact, Dr. James Grubman, a psychologist who provides wealth counseling and training services to financial professionals, notes in the Wharton report that while the first two elements of trust are technical competence and ethical conduct and character, trust in empathetic skills and maturity—what he calls "relationship competence"—may be the most critical element to a successful financial advisor-client relationship. What Grubman sees as the "softer advisory elements of personal counseling and instruction" may naturally lead advisors to understand clients better and to naturally want to do what's in clients' best interests.

Integrating the recent court decisions and new ethics codes into client conversation might begin with a definition of financial advice, something Barbara Roper says is long overdue. "What sets advice apart from a sales recommendation is that advice is offered in the best interest of the client. If that standard doesn't apply, then it's not advice—it's a sale. And we should stop calling it advice," she states.

Leading with a comprehensive definition of unbiased advice instead of cost might catch the consumer's attention. Consultant Bert Schaeffer says what comes through in survey after consumer survey is that the public wants unbiased financial advice. "Consumers need advice, and the more accessible that advice is, the better," says Schaeffer. "I think that was the genesis of the Merrill Lynch rule, to make advice more accessible. The problem with it, however, was that the exception it granted was confusing. Even today, after the rule has been overturned, the vast majority of consumers don't know what to expect as they look for financial advice."

The irony, he says, is "if you asked brokers, 'Do you act in the best interests of clients, the vast majority would respond, 'Yes.' If you then asked, 'Would you be willing to subject yourself to the legal regulations required if you act as a fiduciary?' the answer would be, 'Absolutely, I'm doing it already.' However, I don't think the majority of brokers understand the implications of the legal and regulatory regime they would be subject to if they became registered investment advisers."

Fiduciary status would be difficult for some firms, and impossible for others under current laws, says Schaeffer. Having more registered investment advisers would result in greater litigation risk for the firm, since fiduciary status carries a much higher legal responsibility than does suitability, the standard of care that brokers must adhere to. What's more, Schaeffer foresees a regulatory minefield if broker/dealer firms allow a large number of their brokers to be subject to the Investment Advisers Act, as they would also be subject to the act's prohibition of principal trading.

Explains Schaeffer: "A broker who is also serving a client as an investment advisor may not act as a dealer for the client by selling securities from inventory, for example, without getting prior written consent for each transaction." Once they understand that, they quickly come to the conclusion that, even though they operate in the best interests of their clients and want to act like a fiduciary, they don't want to go that far because their business model will suffer significantly."

## Is More Education the Answer?

Whether or not large numbers of brokers become registered investment advisers, Jim Barnash suggests the Financial Planning Association partner with larger firms to educate the public not only on the court decision and revised ethics, but to define what constitutes a financial plan. "There's an opportunity here for planning to become clear in the minds of consumers," he says. "I'd like to see something simple and effective, like the Got Milk? campaign."

The emphasis of a campaign should be, says Barnash, that looking out at all times for clients' best interests demands a bigger-picture approach. He explains, "When you go to a doctor for the first time, they give you a complete physical, recording height, weight, and blood pressure, just to get to know you before they address the reason for your visit. That's a valuable process and something we've gotten away from in the financial planning profession. We feel it's okay to go right to the sore elbow—what do you need *today*? The new ethical standards for CFPs lead us away from this narrow approach. Someone may come in with a very focused concern, but we can't ignore tax strategies or risk management elements of their situation. Acting in the total best interest of a client requires a comprehensive financial planning perspective, whether it's convenient or not, as well as conversations about issues people don't want to talk about, like long-term care."

Barbara Roper summarizes: "The good news about the lawsuit is that it clears away a bad rule of allowing brokers to offer extensive advisory services outside of the standards that should govern the advice. The bad news is that we still have a ways to go to get atop a rational pro-investor policy. As the SEC confronts these issues, it must acknowledge that disclosure alone is not an answer."

Don Trone, founder of Fiduciary360, which coordinates the resources of the Foundation for Fiduciary Studies and the Center for Fiduciary Studies, agrees with Roper that disclosure is not enough to protect investors, but stresses that disclosure alone does not comply with the laws already on the books. "Education by professional organizations isn't going to change, so we won't see real changes for investors," he says.

## More than Disclosure

Trone notes that the recent reversal of Section 202 recognizes that the intent of the Investment Advisers Act of 1940—an intent reinforced by the U.S. Supreme Court in 1963—was that in addition to providing full disclosure, an investment advisor cannot function in a fiduciary role if there are any conflicts of interest.

According to Trone, in recent years the SEC has based its policy on the first part and ignored the second part. "The SEC is all about full disclosure. Its position is that if you disclose any potential conflicts of interest to consumers, they read your disclosure, and don't understand, it's not your fault," Trone says. "However, we need to have the second part where the law clearly states that an investment advisor cannot have any conflicts of

interest. It's not that you can have conflicts of interest as long as you disclose them. There cannot be conflicts of interest, and that is what the SEC has been unwilling to enforce."

Trone, involved in fiduciary debates for 20 years and appointed by the U.S. Secretary of Labor to be the sole representative from the investment counseling industry on the ERISA Advisory Council, is quick to point out that in the 1990s he admonished broker/dealers on the issue of conflicts of interest—but in the last few years, he's changed his tune.

"I'm now convinced that the wirehouses want to do it right," Trone says. "But the confusion is, how can they do it right when the laws really don't reflect the changes in the industry?"

Trone offers the following example: "Let's say a broker in a wirehouse wants to serve in fiduciary capacity and they absolutely put the interests of the client first. They hire a professional money manager in the course of the relationships, but unbeknownst to the broker, the same money manager participates in an IPO in the other side of the wirehouse. That's a prohibited transaction in the SEC's eyes under the Investment Advisers Act. In the late 1990s, brokerage firms asked for exemption from situations such as this. The brokerage industry realized it couldn't serve in a fiduciary capacity as long as there was the possibility of triggering an unintended prohibited transaction, so they asked for relief, but the SEC wouldn't give it to them."

Just as the Pension Protection Act opened the door for financial advice for 401(k) participants, Trone believes the SEC should provide some prohibitive transaction relief as long as brokers adhere to fiduciary rules. "If the SEC would grant prohibitive transition relief, you'd see every major wirehouse rolling out fiduciary services," he says.

According to Trone, true improvement for consumers requires the SEC to step up and do a complete job. "The SEC realizes that the industry has fundamentally and forever been changed. Yet although it is aware of this, it refuses to create a new regulatory scheme to oversee the changes in the industry," Trone explains. "The truth is that whether we're talking about an individual investor or the trustee of multi-billion-dollar pension funds, the public perception is the SEC is a watchdog agency that ensures that the industry is operating properly. But the reality is that they haven't been doing a complete job, at least from the standpoint of the investment advisory and consulting part of the industry."

In the end, Don Trone says, the impact of the court decision on consumers will depend on what kind of oversight the regulatory agencies provide to monitor how firms handle the decision of whether to convert accounts to a commission basis or register brokers as investment advisers. But a larger concern, he says, is whether Congress might step in to insist that the SEC do a better job at protecting investors' interests.

For now, although the road is being paved for consumers to receive better financial advice, plenty of questions remain: To what extent might insight from the RAND Corporation's study, being conducted on behalf of the SEC, foster a better understanding of the current state of the financial services industry? How might that affect existing laws? With the necessary changes, could the entire industry one day, without reservation, embrace fiduciary duty in an advisory role?

During the time it takes to answer those questions, however, Barbara Roper offers this reminder: "Nobody has to wait for new regulations in order to decide to operate with a higher standard of conduct."

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