# A New Standard for the Ethical Planner

**Life Expectancy Analyses, new to the financial planning market, have the potential to become a standard requirement for planners. Someday soon, NOT getting one on your client may be viewed as a breach of fiduciary duty.**

*In this white paper, Jeffrey Kelvin, Esq., compliance advisor to over 2,000 financial planning firms, discusses the planner's* ***fiduciary duty*** *and the evolution of its interpretation by regulatory bodies. He also introduces a new tool, the* ***life expectancy analysis****, and discusses how its use can help planners meet their fiduciary obligations, developing plans that are more demonstrably suitable to the client's situation and likely prospects, and reducing the planner's liability.*

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**Introduction**

Financial planners must register as investment advisers. Investment advisers are fiduciaries. Fiduciaries have the responsibility to make suitable recommendations to clients in light of their needs, based on a reasonable inquiry into their investment objectives, financial situation and other factors.

One crucial component of the financial planner's duty during the early stages of the professional relationship is that such planner "know the customer." Failure to follow these protocols and methods may be a breach of fiduciary duty and may subject financial planners to increased liability.

Life expectancy analysis has recently evolved to the point that it is substantially more accurate, scientific and dependable than had been the case even as recently as a few years ago. Unlike several years ago, when there were not really any dependable or reputable life expectancy analysis firms on the scene, today there are probably five major providers of this service, and one of them now has a life expectancy product designed expressly for the use of financial planners.

The basic premise of this article is that life expectancy analysis must become an integral and fundamental part of the financial planning process. In the spirit of continuously attempting to improve, evolve and bring innovation to our profession, the financial services practitioner may now, in a formidable fashion, address all sorts of issues which until recently, have not even been on the table.

The use of the life expectancy analysis technique is appropriate within this context. Failure to integrate life expectancy analysis *principles* into the basic financial planning process is not only a breach of fiduciary duty, not only a violation of the "know your customer" rule subjecting the planner to increased liability, but also shortchanges the planning client. The easiest way for the planner to abide by these *principles* is to use the life expectancy analysis *instrument.*

**Financial Planners Must Register as Investment Advisers**

First we will discuss the fiduciary responsibilities of the investment adviser, and whence they arise, in ethics and in law.

It is well settled under the law that the financial services practitioner, who provides comprehensive financial planning services to clients, must become registered as an investment adviser. The specific professional pursuit involved will directly determine where such registration must take place. But such RIA registration must take place somewhere – either at the federal level, with the United States Securities and Exchange Commission, or if not eligible at the SEC level, with the state securities commissioner. In the event that the practitioner does nothing more than provide fee-based financial planning services, then federal registration with the SEC will not be possible, and the planner must become RIA-registered at the state level. However, if the practitioner engages in asset management service activity, either exclusively, or in conjunction with the fee-based financial planning activity, then SEC registration becomes not only possible, but mandated, when the assets under management exceed $30,000,000.

As a practical matter, as long as the specific professional activities of the financial services professional meet all three prongs of an SEC-initiated three-pronged test, then the practitioner must become registered as an investment adviser.

What are the three prongs?

**The first prong** is known as the "advice" test, and the following question is posed: "Does the financial services professional provide advice or analyses about a security?"

**The second prong** is known as the "in the business test." This is an examination of the concept of whether or not the financial planner is holding himself/herself out to the public as being "in the business of providing advice about securities."

**The third prong** is known as the "compensation" test. The question is posed along the lines of whether or not the financial services professional receives any compensation, IN ANY FORM, as a result of having provided the financial planning advice. This compensation test is met if the practitioner receives fee income, commission income as a result of the sale of any product, or some combination of the two.

For more on the three-pronged test, please see *Addendum 1.*

**Investment Advisers are Fiduciaries**

It is well settled that investment advisers are to be viewed under the law as fiduciaries. In the United States Supreme Court case of *Securities and Exchange Commission vs. Capital Gains Bureau*, 375 U.S. 180 (1963), the principle that investment advisers must place the interest of the advisory client ahead of their own interest was clearly established. Although this case dates back 45 years, it is still "good law" today and must be considered by financial planners and investment advisers as part of the practitioner's standard operating procedure. For example, the court stated the following:

*. . . it is hereby declared that the national public interest and the interest of investors are adversely affected . . . when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable*

*such advisers to relieve themselves of their fiduciary obligations to their clients. [375 U.S. 180, 190]*

The Supreme Court in this case also held that the antifraud provisions and legislative history of the Investment Advisers Act of 1940 reflected "congressional recognition of the delicate fiduciary nature of an investment advisory relationship, that a fiduciary is one who owes to another the duties of good faith, trust, confidence and candor, that in a fiduciary relationship, such as with lawyers, doctors and investment advisers, the financial planning client hands over power or property to a fiduciary so that such fiduciary may effectively provide services in an artful and competent manner."

The court stated that because fiduciaries have knowledge and expertise which beneficiaries of the financial services do not have, enjoy or possess, such planning and advisory clients are unable to monitor and effectively evaluate a fiduciary's activities. Fiduciary law seeks to protect beneficiaries of these professional services and encourages them to enter into such fiduciary relationships by reducing the associated risks. (See Financial Planning Association [FPA] White Paper "Regulation of Financial Planners," Jonathan R. Macey, 2002).

Professor Macey reminds us in his white paper for the FPA that there is ample authority for the proposition that fiduciaries owe their clients a duty of loyalty and a duty of care. A duty of loyalty requires, among other things, that fiduciaries place their clients' best interests ahead of their own and not favor one client at the expense of another. This fiduciary duty of care requires that decisions on behalf of a client must be made after gathering every single available piece of relevant information, after deliberating and after acting with "wisdom and caution."

In the *Securities and Exchange Investment Adviser Examination Manual* this government agency has clearly stated that an investment adviser's fiduciary obligations include:

*. . . the duty to render disinterested and impartial advice; to make suitable recommendations to clients in light of their needs, financial circumstances and investment objectives; to exercise a high degree of care to insure that adequate and accurate representations and other information about securities are presented to clients; and to have an adequate basis in fact for its recommendations, representations and projections.*

Not only have the federal regulators emphasized the importance of fiduciary duties to be applied by financial planners and investment advisers, but the state regulators have done so as well. For example, the North American State Securities Administrators, on its website, states the following:

*The anti-fraud provisions of the Investment Advisers Act of 1940 and most state laws impose a duty on investment advisers to act as fiduciaries in dealings with their clients. This means the adviser must hold the client's interest above its own in all matters. Conflicts of interest should be avoided at all costs. . .*

Another interesting element of this equation is the concept of *suitability.* In the year 1994, the Securities and Exchange Commission proposed a suitability rule which would have expressly required investment advisers to consider the suitability of the specific investments and financial planning recommendations made by the adviser. As a practical matter, this suitability proposal failed to reach finalized stage. Despite this fact, there is still an implicit obligation which is imposed upon the adviser concerning suitability.

The SEC has said that an adviser has a duty to:

- Make reasonable investment recommendations independent of outside influences
- Select broker-dealers based on their ability to provide the best execution of trades for accounts where the adviser has authority to select the broker-dealer.
- Always place client interests ahead of its own.
- *Make recommendations based on a reasonable inquiry into a client's investment objectives, financial situation and other factors*.

The life expectancy analysis should, I would argue, be a part of the "reasonable inquiry" to which the SEC refers in that last point.

## The Financial Planning Process

The Certified Financial Planner Board of Standards promulgates the specific financial planning process which certified financial planners are to follow when undertaking and engaging in the financial planning process. In a nutshell, the CFP Board has mandated that the following six-step approach must be employed by the CFP practitioner.

The life expectancy analysis is relevant to each step, as my comments below suggest.

1. Establishing and defining the client-planner relationship.

The financial planner should clearly explain or document the services to be provided to the client. The planner should explain fully how he or she will be paid and by whom. The client and the planner should agree on how long the professional relationship should last and on how decisions will be made. Both the client's and the planner's responsibilities should be defined.

*Comment: One of the key planner responsibilities is to make sure all the relevant facts are gathered, that nothing pertinent is omitted. I would recommend that collecting the information to complete the life expectancy analysis be incorporated as a matter of course when new clients are in their fifties or older.*

2. Gathering client data, including goals.

The financial planner should ask for information about the client's financial situation. The client and the planner should mutually define the client's personal and financial goals, understand the client's time frame for results and discuss, if relevant, how the client feels about risk. The financial planner should gather all the necessary documents before giving the client the advice which the client may need.

*Comment: Nothing has greater influence on the client's financial goals, time frames and feelings about risk as their notions about how long they are likely to live. If they believe their time is short, they will view putting their estate in order and assuring funds for medical expenses as the essentials. On the other hand, if they believe they will live for many years, their preoccupation will be to make their funds last. It would be well to gather the medical information required for the life expectancy evaluation first, because that evaluation can tell you what other information is truly essential to creating an appropriate financial plan.*

3. Analyzing and evaluating your financial status.

The financial planner should analyze the client's information to assess the client's current situation and determine what the client must do to meet the client's goals. Depending on what services the client has asked for, this could include analyzing the client's assets, liabilities and cash flow, current insurance coverage, investments or tax strategies.

*Comment: With an older client, the most crucial factor in analyzing the client's cash flow, insurance coverage, investments and tax strategies is certainly their life expectancy. The results of the life expectancy evaluation are indispensable to a proper analysis of the client's financial situation.*

4. Developing and presenting financial planning recommendations and/or alternatives.

The financial planner should offer financial planning recommendations that address the client's goals, based on the information which the client provides. The planner should go over the recommendations with the client to help the client understand them so that the client can make informed decisions. The planner should also listen to the client's concerns and revise the recommendations as appropriate.

*Comment: A life expectancy evaluation enables you to give the client much deeper insight into their needs, and the implications for their finances are therefore much easier for them to see.*

5. Implementing the financial planning recommendations.

The client and the planner should agree on how the recommendations will be carried out. The planner may carry out the recommendations or serve as the client's "coach," coordinating the whole process with the client and other professionals such as attorneys or stock brokers.

*Comment: The client who is more convinced that the plan will meet his needs is much more likely to cooperate in carrying it out. Again, the life expectancy evaluation makes for a more "convinced" and motivated client.*

6. Monitoring the financial planning recommendations.

The client and the planner should agree on who will monitor the client's progress towards the client's goals. If the planner is in charge of the process, he or she should report to the client periodically to review the client's situation and adjust the recommendations, if needed, as the client's life changes.

*Comment: This suggests another role for the life expectancy evaluation: as an aid to appropriately adjusting the financial plan over time to meet the evolving needs of the client. Some planners who are using the life expectancy analysis are telling clients they will get it updated every two or three years.*

**New Science for Planning**

To be sure, the life expectancy analysis is a relatively new technique. Thanks to the impressive development of this protocol, the financial services professional may now in a formidable fashion address all sorts of issues which had in the recent past, not even been on the table.

At the time of this writing, there are five principal and leading providers of the life expectancy service. These are: 21st Services, AVS, EMSI, Fasano, and ISC Services. I visited 21st Services and was favorably impressed with the scientific and methodical principles which this firm has embraced in order to modernize and perfect the life expectancy analysis concept.

21st has adopted a sophisticated underwriting system which includes a "rules based" underwriting system which is used to predict the life expectancy of the client. In a nutshell, this protocol features, among other things, an underwriting system which is structured so as to rule out subjectivity and yield a more scientific, reproducible and trustworthy life expectancy outcome. This, apparently, is different from the underwriter-judgment-based approach which many of the other life expectancy firms have adopted.

21st has developed a life expectancy report to meet the specific needs of the financial professional, the Customized Longevity Planning Report. In marketing materials used by 21st, the following examples suggest the very different needs a client will have if his/her life expectancy is long – than if it is short.

**Example # 1:** He's 63. He's divorced, the father of three . . . one still in high school. What would you [the financial planner] recommend he do about life insurance if you [the planner] knew his life expectancy was to age 70? What if it was to age 90? (A life insurance underwriter may tell you the client is "standard" or "impaired," but they won't translate that into a life expectancy prediction. Getting a life expectancy estimate could help vastly with decisions about term conversion, new policy purchase and life settlements.)

**Example # 2:** He's 66. He's a surgeon retired on disability. $8.5 million in assets. Two $2 million term policies, expiring in the next 10 years. What would you recommend he do with them if you [the planner] knew his life expectancy was to age 68? What if it was to age 86? (Does he need to just let the term policies ride – or move into a new policy that will meet the estate tax needs his heirs will face if the $8.5 million estate grows steadily for 20 years? Knowing the client's life expectancy would dictate completely different actions.)

**Example # 3:** She's 61. She's selling her successful business, retiring early. How would you build a retirement plan for her if you knew her life expectancy was to age 65? What if it was to age 85? (Early retirement plus long life means conserving the proceeds of the sale of her business will be the financial plan's most critical task. But if she has a short life expectancy, perhaps her focus should be on enjoying the fruits of her labor while she can.)

Based on the fact that such a service is now available, the financial planner *should be using it* in order to fully discharge his or her legal, regulatory and compliance related obligations.

**Conclusion**

Financial planners must register as investment advisers. Investment advisers are fiduciaries. Fiduciaries must do everything possible in the course of undertaking the planning process to fully, comprehensively and exhaustively ascertain any and all aspects of the planning client's situation. This stands as an express prerequisite to the successful discharge of the planner's fiduciary responsibility. Failure to do so is arguably a breach of fiduciary duty and may subject the planner to liability. Furthermore, it shortchanges the client. In light of the fact that the valuable new tool of life expectancy analysis is now available, it is something that the financial services professional should integrate into the basic planning process.

*Addendum 1*

## The Three-pronged Test

The SEC uses the three-pronged test to determine whether the provider of financial planning services must be registered as an RIA. All three prongs of the test must be met. If they are, the planner assumes all the duties and responsibilities expected of Registered Investment Advisors under SEC regulation.

**First Prong**

The first prong is known as the "advice" test, and the following question is posed: "Does the financial services professional provide advice or analyses about a security?"

This first prong actually contains two sub-parts and these are: (a) what is "advice or analyses?" and (b) what is a "security?"

Advice may take on any format or incarnation. Providing verbal assistance to a client about finances is "advice or analyses." A written financial plan is too. A telephone consultation is as well. A financial planning meeting at a client's office, office of their attorney, CPA or stockbroker would also be advice. In short, the rule is intentionally drafted, viewed, construed and applied in an exceedingly broad fashion. A wide net is cast. Any time and in any situation in which a financial planner is advising a client, the first part of the first test will be deemed met.

Next question: What is a "security?" Answer: Just about any and every type of financial instrument.

The federal securities laws define a "security" as follows:
*"Security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a*

*national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing.*

In short, any instrument or product which a financial planner discusses with a client will, based upon the broadly based definition above, be deemed to be a security.

In conclusion, any financial services professional who is undertaking the comprehensive job which is required of him or her, will be answering "YES" to the first prong of our three-pronged test.

**Second Prong**
The second prong of our three-pronged test is known as the "in the business test." This is an examination of the concept of whether or not the financial planner is holding himself/herself out to the public as being "in the business of providing advice about securities." This test may and will be met in several different ways. For example, if the practitioner has a professional designation such as a CFP, CFA or ChFC, then by virtue of having this designation and by virtue of using such professional designation, the practitioner will be deemed to be holding himself or herself out to the public as "being in the business" of providing investment advice.

Even without the usage of a professional designation, the "in the business test" will be deemed to be met if the name of the practitioner's firm implies that the members and principals of the firm are "in the business" of providing advice about securities. As such, a company known as Capital Financial Advisers, or Jones Financial Planning, for example, meets in the "in the business test" in that the title of the firm suggests that the firm is holding itself out.

**Third Prong**
The final prong of our three-pronged test is known as the "compensation" test. The question is posed along the lines of whether or not the financial services professional receives any compensation, IN ANY FORM, as a result of having provided the financial planning advice. This compensation test is met if the practitioner receives fee income, commission income as a result of the sale of any product, or some combination of the two.

In short, in today's environment, the financial planner, by reason of the specific professional activities engaged in, will be answering "yes" to all three questions of the three-pronged test, and as such must become registered as a Registered Investment Adviser.

*Addendum 2*

## The SEC View: Keeping Your Fiduciary Duty in Focus

On February 27, 2006, at the Eight Annual Investment Adviser Compliance Summit held in Washington, D.C., Lori A. Richards, Director of the Office of Compliance Inspections and Examinations at the Securities and Exchange Commission, delivered a paper entitled *Fiduciary Duty: Return to First Principles.* What follows are some of her remarks:

(1) All advisory firms, whatever their size, type or history in the business, owe their advisory clients a fiduciary duty. Many firms are acutely aware of their fiduciary obligation and ensure that it informs, educates and guides their dealings and decisions. But, one only has to look at our enforcement actions and deficiencies found in exams to draw the conclusion that the application of fiduciary duty is not as embedded in many firms' cultures as it could be. In fact, I'm far from certain that all advisory firms understand their fiduciary obligations, and how they apply in the context of their own operations. Some advisers have seemed to be aware of the fiduciary duty in kind of an ethereal way — "I know it's out there but I don't really know what it is." Others have looked at fiduciary duty as strictly a compliance or legal function – not fully appreciating its significance to *all* employees of the firm. Either view is dangerous.

(2) Fiduciary duty. Understanding "fiduciary duty" is critical, because it is at the core of being a good investment adviser. In a very practical sense, if an adviser and the adviser's employees understand the meaning of fiduciary duty and incorporate this understanding into daily business operations and decision-making, clients should be well served, and the firm should avoid violations and scandal. Indeed, I believe that, even if advisory staff are not aware of specific legal requirements, if their decisions large and small and every day are motivated and informed by *doing what's right by the client*, in all likelihood, the decision will be right under the securities laws.

(3) This is why, as an examiner, I care about advisers' fiduciary duties. I think that knowledge and familiarity with one's fiduciary duty can help firms *avoid* compliance violations. And, avoidance of violations is in everyone's best interests—yours, your clients and our markets. As examiners, we prefer to find highly compliant firms with strong compliance controls that prevent violations.

(4) [Let's] look more closely at the concept of fiduciary duty. Many different types of professions owe a fiduciary duty to someone—for example, lawyers to their clients, trustees to beneficiaries, and corporate officers to shareholders. Fiduciary duty is the *first principle* of the investment adviser—because the duty comes not from the SEC or another regulator, but from common law. Some people think "fiduciary" is a vague word that's hard to define, but it's really not difficult to define or to understand. Fiduciary comes from the Latin word for "trust." A fiduciary must act for the benefit of the person to whom he owes fiduciary duties, to the exclusion of any contrary interest.

(5) Now, some might wonder why the concept of fiduciary duty came to be applied to advisers. The Investment Advisers Act does not call an adviser a fiduciary. In fact, that word does not appear in the Act. But, the Supreme Court recognized congressional intent and held that the Advisers Act: *"reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."*

And, the Court also said that investment advisers are fiduciaries with *"an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' . . . clients."*