

# Chapter 2

## Ethical Issues in Financial Planning

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Reading this chapter will enable you to:

2–3 *Analyze ethical issues that affect financial planners.*

**F**inancial planners have a fiduciary relationship with their clients. There is no greater level of fiscal responsibility. In recognition of this requirement, CFP Board developed its *Standards of Professional Conduct*, which includes the *Code of Ethics and Professional Responsibility* (the Code). While it is not important to know all the details of the Code by Principle or Rule numbers, it is important to know what the Code requires.

In recent years, examples of unethical behavior have made headlines in the print media, and numerous television programs on ethics in the public and private sectors have been aired. Unethical behavior by individuals and groups not only hurts other people and organizations, it also adversely affects the industries, government agencies, and professions in which it occurs.

More than ever, financial planners should understand their legal obligations and be aware of the ethical issues involved in all stages of the planning process. Both newcomers to the field and those who have practiced financial planning for a number of years should constantly remind themselves of the responsibilities inherent in the client-planner relationship.

# Professional Codes of Ethics

Almost every professional organization chooses to develop a code of ethics that embodies principles for behavior. It generally includes a list of rules or standards for professional conduct, as well as a set of disciplinary procedures. An organization's code of ethics and its standards of practice represent that organization's attempt to provide guidelines for action. Some groups publish interpretations of their principles and document misconduct cases brought before them. Principles and rules embodied in a code of ethics are not rules of law, although most standards have their basis in laws and regulations.

Most professional organizations strive to monitor and enforce their rules of professional conduct. Violators are subject to private or public censure, suspension of membership, expulsion from the organization, or suspension or revocation of a professional designation. Enforcement is one way organizations try to ensure that the public (i.e., the client) is protected against fraudulent or unethical practices.

CFP Board's *Code of Ethics and Professional Responsibility* is reproduced as Appendix B at the end of this module. The Code is organized around seven Principles (which you should know):

***Integrity.*** Provide professional services with integrity.

- Integrity demands honesty and candor which must not be subordinated to personal gain and advantage. Certificants are placed in positions of trust by clients, and the ultimate source of that trust is the certificant's personal integrity. Allowance can be made for innocent error and legitimate differences of opinion, but integrity cannot co-exist with deceit or subordination of one's principles.

***Objectivity.*** Provide professional services objectively.

- Objectivity requires intellectual honesty and impartiality. Regardless of the particular service rendered or the capacity in which a certificant

functions, certificants should protect the integrity of their work, maintain objectivity and avoid subordination of their judgment.

**Competence.** Maintain the knowledge and skill necessary to provide professional services competently.

- Competence means attaining and maintaining an adequate level of knowledge and skill, and application of that knowledge and skill in providing services to clients. Competence also includes the wisdom to recognize the limitations of that knowledge and know when consultation with other professionals is appropriate or referral to other professionals is necessary. Certificants make a continuing commitment to learning and professional improvement.

**Fairness.** Be fair and reasonable in all professional relationships. Disclose conflicts of interest.

- Fairness requires impartiality, intellectual honesty and disclosure of material conflicts of interest. It involves a subordination of one's own feelings, prejudices and desires so as to achieve a proper balance of conflicting interests. Fairness is treating others in the same fashion that you would want to be treated.

**Confidentiality.** Protect the confidentiality of all client information.

- Confidentiality means ensuring that information is accessible only to those authorized to have access. A relationship of trust and confidence with the client can only be built upon the understanding that the client's information will remain confidential.

**Professionalism.** Act in a manner that demonstrated exemplary professional conduct.

- Professionalism requires behaving with dignity and courtesy to clients, fellow professionals, and others in business-related activities.

Certificants cooperate with fellow certificants to enhance and maintain the profession's public image and improve the quality of services.

*Diligence.* Provide professional services diligently.

- Diligence is the provision of services in a reasonably prompt and thorough manner, including the proper planning for, and supervision of, the rendering of professional services.

Principles in the Code of Ethics are explained and enhanced by a series of *Rules of Conduct*. Rules are presented in the following categories:

1. Defining the Relationship with the Prospective Client or Client
2. Information Disclosed To Prospective Clients and Clients
3. Prospective Client and Client Information and Property
4. Obligations to Prospective Clients and Clients
5. Obligations to Employers
6. Obligations to CFP Board

As identified in the Code's introductory material, the *Rules of Conduct* establish the high standards expected of certificants and describe the level of professionalism required of certificants. These rules are binding on all certificants, regardless of their title, position, type of employment or method of compensation, and they govern all those who have the right to use the CFP® marks, whether or not those marks are actually used. The universe of activities engaged in by a certificant is diverse, and a certificant may perform all, some or none of the typical services provided by financial planning professionals.

Some Rules may not be applicable to a certificant's specific activity. As a result, when considering the *Rules of Conduct*, the certificant must determine whether a specific Rule is applicable to those services. A certificant will be deemed to be in compliance with these rules if that certificant can demonstrate that his or her employer completed the required action. Violation of the *Rules of Conduct* may subject a certificant or registrant to discipline. Because CFP Board is a certifying and standards-setting body for those individuals who have met and continue to meet CFP Board's initial and ongoing certification requirements, discipline extends to the rights of registrants and certificants to use the CFP® marks. Thus, the rules are not designed to be a basis for legal liability to any third party.

Rule 1.4 has one of the more interesting and significant changes in the current iteration of the Code. For the first time, the Code specifically states that a certificant, when providing financial planning (or material elements of the planning process), owes the client the duty or care of a fiduciary as defined by CFP Board. The definition provided in the terminology section of the Code reads: "Fiduciary: one who acts in utmost good faith, in a manner he or she reasonably believes to be in the best interest of the client."

CFP Board has created a Frequently Asked Questions (FAQ) document covering various areas of the current iteration of the *Standards of Professional Conduct*. If you have questions about how the *Standards* may apply to you, the document is worth viewing. You can download the FAQs at: [www.cfp.net/Downloads/FAQ\\_CFP\\_Board\\_Standards.pdf](http://www.cfp.net/Downloads/FAQ_CFP_Board_Standards.pdf).

As you read this module, try to relate the information presented to the Code provisions. If you are a member of another professional organization, review its code of ethics. You will find that although codes of ethics vary in content, length, and format, common themes emerge, such as protection of the public interest, the duty to disclose, professional competence, and adherence to laws, rules, and regulations. These issues

apply to financial planning, in general, and to the planner's role as an investment adviser.

## The Fiduciary Nature of the Client-Planner Relationship

The client-planner relationship may be viewed as a fiduciary relationship. In a landmark decision that helped define that relationship, the U.S. Supreme Court described an investment adviser's fiduciary duty as including, "... an affirmative duty of utmost good faith, and full and fair disclosure of all material facts." (*SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 1963.)

Although this description of the fiduciary duty was used in describing investment advisers, it also applies to financial planners. In Release IA-770 (1981), and later in IA-1092 (1988), the SEC clearly indicated that financial planners fall within the definition of investment advisers. This is hardly surprising; it is difficult to think of a situation in which an individual engages in comprehensive financial planning without giving investment advice.

According to *Black's Law Dictionary*, a fiduciary relationship exists whenever one person trusts in or relies upon another. More specifically, a fiduciary relationship arises whenever "confidence is reposed on one side, and domination and influence result on the other." When financial planners hold themselves out as possessing special skills or expertise, a fiduciary relationship arises. In such a relationship, a planner has the duty to act primarily for the client's benefit.

# Duties Owed to a Client

The following discussion is based on material appearing in three seminal texts, each of which discusses regulation and liability issues affecting financial planners:

- Bernzweig, Eli P., *The Financial Planner's Legal Guide*. Englewood Cliffs, NJ: Prentice-Hall, 1986.
- Toman-Cubbage, Cheryl, *Professional Liability Pitfalls for Financial Planners*. Englewood Cliffs, NJ: Prentice-Hall, 1988.
- Vessenes, Katherine, *Protecting Your Practice*. Princeton, NJ: Bloomberg Press, 1997.

As summarized by Toman-Cubbage, the specific duties a financial planner owes to a client are the fiduciary duty, the duty to disclose, the duty to diagnose, the duty to consult, and the duty to keep current. In many instances, these duties overlap. (Bernzweig presents a similar list in his discussion of liability-producing conduct.)

## The Fiduciary Duty

As suggested above, the fiduciary duty is the fundamental duty a professional owes a client. Protection of the public interest means acting in the client's (best) interest. A financial planner must put the client's interest first. Examples in the area of investment planning are placing service to the client above income to the planner and disclosing any potential conflicts of interest when recommending investments. Key to the fiduciary relationship is the rendering of impartial advice. CFP certificants are held to a fiduciary standard by CFP Board's *Standards of Professional Conduct*.

## The Duty to Disclose

The duty to disclose is the next critical element in the fiduciary relationship. Disclosure is dealt with extensively in government regulations and professional codes of ethics. A financial adviser should deal fairly with clients and avoid conflicts of interest. The obvious way to deal with conflicts of interest that cannot be eliminated fully is to disclose all relevant information to the client.

When an individual registers with the SEC as an investment adviser, Form ADV requires extensive information that must be given to the client. The information includes, among other things, descriptions of the adviser's services, advisory fees charged, how securities are analyzed, the adviser's affiliations, and a description of the adviser's education and business background.

In the area of financial planning, one of the most crucial disclosures is informing the client of the risks inherent in investments that are being considered. A financial planner who fails to disclose all relevant and material information about an investment that he or she recommends to a client could face a liability suit. Additionally, SEC Rule 10b-5, relating to the Securities Exchange Act of 1934, makes unlawful false or misleading statements relating to the purchase or sale of a security. Numerous other antifraud provisions apply to the failure to disclose.

## The Duty to Diagnose

As Bernzweig puts it, "The duty to diagnose is the crux of the planner's responsibility." When a financial planner makes any kind of recommendations to a client, investment or otherwise, the planner does so in light of the current economic environment and the client's risk tolerance level, financial circumstances, present portfolio, and stated goals. The duty to diagnose is important in all stages of the financial planning process. When financial planners gather and analyze client

information, they must strive to learn everything necessary to make recommendations appropriate to the client. When planners prepare, implement, periodically review, and revise a financial plan, they must be aware of changes in the client's situation and the total investment environment, including the phase of the business cycle, investment performance, and tax changes.

Inherent in the duty to diagnose is the concept of *investor suitability*, which refers to matching an investor's sophistication, financial means, and risk tolerance with the appropriate investment. New York Stock Exchange Rule 405 is known as the "Know Your Customer" rule and stresses the importance of learning the essential facts. Rule 405 focuses on gathering essential information on all customers, transactions, and accounts, including information about the customer's investment knowledge and financial goals. The FINRA suitability rule requires a broker-dealer to have reasonable grounds for believing that a particular investment recommendation is suitable for the client—suitable in terms of the client's overall financial situation, investment objectives, and risk tolerance level.

## The Duty to Consult

Financial advisers should be aware of their limitations. If a planner has any doubts concerning an issue that goes beyond his or her level of personal competence, an expert in that area should be consulted. Because comprehensive financial planning involves so many fields (e.g., insurance, pension planning, law, and accounting), one individual is unlikely to be an expert in each field. The failure to consult a specialist when needed could be deemed negligent conduct on the part of the planner and thus be a basis for liability.

A discussion of the duty to consult logically leads to the issue of practicing in areas where a planner is not properly licensed. The most commonly acknowledged limitation is the unauthorized practice of law.

This could include recommendations regarding the terms of any legal document or advice on tax issues. Additionally, in many states it is illegal for a planner to provide advice regarding insurance if he or she is not licensed as an agent or insurance adviser.

## The Duty to Keep Current

Because the financial services industry changes constantly, financial planners must “keep current” on how those changes affect their clients’ plans. For CFP certificants registered with CFP Board, there are continuing education requirements. If an individual holds himself or herself out to the public as a professional in a specific field, that individual has a duty to keep reasonably abreast of current practice and information in that field.

## *Practice Standards*

As part of the *Standards of Professional Conduct*, CFP Board has included *Practice Standards*. In the words of the Board:

### **Statement of Purpose for *Financial Planning Practice Standards***

*Financial Planning Practice Standards* are developed and promulgated by Certified Financial Planner Board of Standards Inc. (CFP Board) for the ultimate benefit of consumers of financial planning services.

These *Practice Standards* are intended to:

1. Assure that the practice of financial planning by CERTIFIED FINANCIAL PLANNER™ professionals is based on established norms of practice;
2. Advance professionalism in financial planning; and
3. Enhance the value of the financial planning process.”

It should be understood by the student that *Practice Standards* do not provide ethical principles and rules as does CFP Board's *Code of Ethics and Professional Responsibility*. *Practice Standards* are, instead, concerned with what constitutes good practice. The *Standards* are based on the steps of the financial planning process. So, the 100 Series refers to the first step in the financial planning process. The 200 Series refers to the second step, and so on.

The approved *Practice Standards* are:

- 100 Series—Establishing and Defining the Relationship With the Client
  - a. 100-1—Defining the Scope of the Engagement
- 200 Series—Gathering Client Data
  - a. 200-1—Determining a Client's Personal and Financial Goals, Needs and Priorities
  - b. 200-2—Obtaining Quantitative Information and Documents
- 300 Series—Analyzing and Evaluating the Client's Financial Status
  - a. 300-1—Analyzing and Evaluating the Client's Goals, Needs and Priorities
- 400 Series—Developing and Presenting the Financial Planning Recommendation(s)
  - a. 400-1—Identifying and Evaluating Financial Planning Alternative(s)
  - b. 400-2—Developing the Financial Planning Recommendation(s)
  - c. 400-3—Presenting the Financial Planning Recommendation(s)

- 500 Series—Implementing the Financial Planning Recommendation(s)
  - a. 500-1—Agreeing on Implementation Responsibilities
  - b. 500-2—Selecting Products and Services for Implementation
- 600 Series—Monitoring
  - a. 600-1—Defining Monitoring Responsibilities

Full text of these standards is included in Appendix A of this module. According to the Board, “A *Practice Standard* establishes the level of professional practice that is expected of CFP Board designees engaged in personal financial planning. The services provided depend on the facts and circumstances of a particular situation.”

The most current information may be obtained by accessing the Board’s website at [www.cfp.net](http://www.cfp.net).

## Maintaining Ethical Standards in the Profession

Members of the financial services industry are concerned about continued ethical behavior on the part of the industry’s professional practitioners. Individuals in the industry should take it upon themselves to review relevant regulations and professional guidelines. Most professional organizations have ethics committees that publish articles describing ethical behavior in specific situations. Students may want to consider contacting the professional organizations to which they belong for further information on ethics.

# Due Care for the Financial Professional

Much has been written about the need for due diligence by the financial professional. The obligation to act with due diligence when recommending any investment, is derived from the Securities Act of 1933 and the Securities Exchange Act of 1934.

Unfortunately, the history of the term *due diligence* has parallels to those of the terms *Band-Aid* and *Kleenex*. Due diligence has become so overused as to almost lose its meaning and impact; many financial professionals currently use the term with this less restricted meaning. Clients and lawyers may see it differently. By claiming to act with due diligence in an area outside of securities, a financial professional may be accepting more liability than is necessary or prudent.

Most states allow an insurance agent to merely assure a client that an insurer is licensed in the state and is in good standing financially with the insurance commissioner's office. The reasoning behind this is that it is difficult, if not impossible, for an agent or any financial professional to find out much more than this about an insurance company or its sales material.

However, there are a number of rating services available that evaluate insurance companies. Standard & Poor's, Moody's, Duff & Phelps, and the A.M. Best Company are the most recognized and respected. Unfortunately, their information is often months out of date by the time their ratings are published. Surprising corporate insolvencies over the last few decades showed us that even these giants with expert staffs cannot always predict what will happen. Even though their data is somewhat outdated, these rating services are good sources of information. However, checking all of them would still not qualify as due diligence.

Influential centers for financial professionals have encouraged the use of the term *due care* rather than *due diligence* when evaluating insurance

companies. This term conveys the professional's concern without bringing in the liability implicit in the term *due diligence*. There is no legal requirement to do an in-depth analysis of all factors surrounding an insurance company or the accuracy of its sales material, but there is such a requirement in the securities legislation relating to due diligence.

Simply put, it is in the best interest of the financial professional to avoid using the term *due diligence* in any area other than securities. More specifically, in the area of life insurance, the term *due care* is preferred.

## CFP Board Candidate Fitness Standards

Candidates for CFP certification must meet certain character and fitness standards, as required by CFP Board. The following identifies those standards (excerpted from CFP Board's website: [www.cfp.net/certificants/conduct.asp#top](http://www.cfp.net/certificants/conduct.asp#top)).

### *Candidate Fitness Standards*

CFP Board's *Candidate Fitness Standards*—character and fitness standards for individuals seeking to obtain CFP® certification—became effective on January 1, 2007. As part of the fitness standards, CFP Board established a list of transgressions that will be presumed to be unacceptable, and thus bar certification, unless the Disciplinary and Ethics Commission (Commission) reconsiders and makes a different determination after a review. This list includes:

- One personal or business bankruptcy filed within the last five years.
- More than one judgment lien.
- Revocation or suspension of a non-financial professional (real estate, attorney) license, unless the revocation is administrative in nature, i.e.

the result of the individual determining not to renew the license by not paying the required fees.

- Suspension of a financial professional (registered securities representative, broker-dealer, insurance, accountant, investment adviser, financial planner) license, unless the suspension is administrative in nature, i.e. the result of the individual determining not to renew the license by not paying the required fees.
- Felony conviction for non-violent crimes (including perjury) within the last five years.
- Felony conviction for a violent crime other than murder or rape that occurred more than five years ago.

CFP Board is concerned about the qualifications of those seeking to become CFP Board certificants. As a result, the Board makes judgments as to candidate fitness. Candidates who are rejected by CFP Board may petition the Board for reconsideration. The process is outlined in the *Candidate Fitness Standards* document, which may be downloaded from the link above, or viewed in Appendix C at the end of this module.