Don't Get Burned by the Financial Planner "Name Game"

Consumer Federation of America
National Institute for Consumer Education

Table of Contents

Commission-based.
Fee and commission.
Fee-based.
Fee-offset.
Fee-only.

What's going on with all the different names that financial planners use to describe themselves?

Over the past decade, those in the financial services industry have recognized that consumers expect more than just products from financial service providers. They want an objective guide through the increasingly bewildering world of personal finance. This realization has brought about a dramatic change in the way these firms and individuals market themselves to the public. Today, everyone from accountants to bankers to brokers is calling himself or herself a "financial planner," "financial advisor," "investment consultant," or some such title. Of course, all claim to be your best source of personal finance advice. Unfortunately, despite the dramatic changes in marketing strategy and the impressive new titles, most have changed little about the way they do business.

The Consumer Federation of America and National Institute for Consumer Education have produced this brochure to help consumers distinguish between those "financial advisors" who are really salespeople and those who actually provide objective advice.

Why you need to understand how your financial planner is compensated

When you select a financial advisor, there are a number of factors you must take into account—expertise, integrity, experience, even compatibility. But if you are looking for objective advice, you can't ignore the question of how that advisor is compensated.

A relatively small percentage of the individuals offering financial advice actually get paid exclusively for giving such advice. The majority earn some or all of their income selling mutual funds, annuities, insurance, and other financial products to implement their recommendations. "Advisors" who are also salespeople, however, inevitably face a conflict of interest and will almost certainly be tempted to steer clients into products in which they have a financial interest. The greater the advisor's dependence on commission income, the greater the conflict. In the end, that conflict can cost you, both in out-of-pocket expenses and in the quality of advice you receive.

Long-term cost

One of the chief attractions of commission-based financial planning is that it appears affordable. Typically, commission-based planners charge a relatively low fee, or no fee, for the "advice," expecting to earn the real money on the back end, when they sell the products to implement their recommendations. When you buy a product to implement that plan, however, a percentage of the money you spend goes to pay a commission to the planner. Ultimately, the price you pay for a financial plan includes not just the fees, but also the commissions you pay to purchase products to implement the plan's recommendations. In assessing the costs of financial planning, therefore, you have to assess the total costs, including the costs of implementation.

Quality of advice

The increase in implementation costs is not the only price you pay for commission-based planning. You may also pay in the form of poor advice. After all, when a financial "advisor" earns most or all of his or her money as a financial salesperson, the product sales tend to drive the process. In the worst-case scenario, the planning becomes nothing more than window dressing to attract clients for the real moneymaking business of selling products. Clients are offered one-size-fits-all plans that inevitably lead to the purchase of a handful of high-commission products.

Even those commission-based advisors who attempt to offer comprehensive financial advice still can find themselves biased by compensation considerations when it comes time to implement their recommendation. After all, the more the advisor lowers the initial fees to attract business, and the more time he or she spends on the planning process, the more he or she must earn in the implementation phase to make that investment of time pay off. Under such circumstances, even the best of commission-based planners is unlikely to recommend no-load or low-load products, for example. Other less scrupulous planners may recommend an investment, such as a particular mutual fund or annuity, simply because of the special incentives or higher commissions they receive.

The temptation for planners to recommend higher commission products carries another risk for clients. Product sponsors tend to offer higher commissions on those products that are more difficult to sell, because they are riskier. Thus, in pushing higher commission products, the planner may encourage you to take unnecessary risks with your money.

An important word about your best interests:

When advisors are also salespeople, they bring a silent third party into the relationship between planner and client. Instead of working solely for you, as your financial advisor, they also owe allegiance to the product sponsors, brokers, and insurance companies for whom they also work. This makes it all but impossible for the advisor to fulfill his or her fiduciary duty to put clients' interests first, and all but impossible for the client to determine whose interests are really being served.

Why "Fee-only" is probably best for you

So, if you are looking for objective financial advice, a fee-only financial planner is probably your best bet. Fee-only financial planners are compensated solely by fees paid by their clients. They can be paid in a variety of ways — a flat fee or retainer, an hourly fee, a percentage of assets under management, or a percentage of income from investments. The key is that they do not accept commissions or compensation from any other source.

Fee-only financial planning does not necessarily eliminate every conceivable form of conflict-of-interest. When fee-only planners "sell" portfolio management services, for example, they may have a financial incentive to recommend those services to clients. The fee-only approach is, however, subject to fewer conflicts than any other form of financial advice. Furthermore, because fee-only planners are compensated solely by the client, there are no hidden third parties in the relationship and, thus, no divided loyalties.

Some have argued that fee-only financial planning is too expensive for many average investors. For those with only modest savings, this may often be the case. While it is not true that fee-only financial planners work only with wealthy clients, you do have to have substantial investable assets (say $250,000 outside your company pension plan) to make most fee-only planners' fees affordable.

Feeling intimidated about the whole prospect of relying upon a financial planner? Our purpose is not to scare you away from doing so. An honest financial planner can be of real value to a consumer who lacks the confidence and know-how to get started. The financial planning industry exists today because of a real need — consumers recognize they may have to take steps to safeguard their future, but are uncertain as to what to do… or, just as importantly, what not to do. Our chief intention is to make sure that you have the information you need in order to act wisely in selecting a planner who will put your needs ahead of his or her own.

The Financial Planning "Name Game"

If a fee-only financial planner is probably your best bet, what about all those other planners out there? As consumers have started to wake up to the conflicts of interest that result from commission-based compensation, more and more financial planners have adopted confusing terminology designed to obscure how they are compensated. Here are a few of the most common that you should be on the look-out for:

Fee-and-commission

This is the now somewhat out-of-fashion term for a planner who earns a fee for developing a financial plan, then earns commissions selling the products to implement that plan. For years, planners were able to sell this arrangement as being in their clients' best interests on the grounds that they were more objective than commission-only salespeople and more affordable and convenient than fee-only planners. Since consumers have become more conscious of the total costs of fee-and-commission planning and the incentives commission-dependent planners have to steer them into costly and possibly inappropriate products, few planners now use this relatively candid terminology, though the majority continue to practice in this fashion.

Fee-based

This is today's more fashionable terminology for fee-and-commission financial planning. The conflicts are the same, but the candor is gone. Some "fee-based" financial planners will tell clients they can work either on a fee-only basis or on a fee-and-commission basis if the client wants to implement the plan through them. Somehow, however, the bulk of their clients end up as fee-and-commission clients. The term "fee-based" is misleading, so you should be wary of those who use it.

Fee-offset

Under a fee-offset arrangement, a planner imposes a fee for drawing up a strategy, and then reduces up to 100 percent of that fee to account for any commissions that may be earned in implementing the plan. The problem of commission bias is less obvious, but it remains. After all, if a financial plan costs $2,000 and the planner earns $10,000 in commission for selling the needed products, he or she will be able to pocket $8,000 in conflict-producing commissions… even after totally offsetting the cost of the original plan.

Getting more information

How can a typical financial consumer get through this confusing process… without paying a penalty in terms of high commissions or bad advice? The first step is to recognize that you can't just rely on what the financial planner tells you. There are a number of independent sources of information that you can, and should, check when you select a financial planner:

Your state financial regulatory agencies

Your state financial regulatory agencies, particularly the securities agency, can provide a variety of useful information. You can generally find state agencies listed in the blue pages of your phone book. Or, for the number of your state securities agency, you can call the North American Securities Administrators Association at 202-737-0900. The National Association of Insurance Commissioners, at 816-842-3600, can give you the telephone number of your state insurance department.

1. **If your planner has fewer than $25 million in assets** under management, all but four states require the firm to be registered as an investment adviser with the state securities agency. (Advisors with more than $25 million in assets under management must register with the Securities and Exchange Commission. See the following page for more information.) Many states also require individual representatives of both large and small firms to register separately. Never work with a financial planner who is not registered as an investment adviser at either the state or federal level, since an unregistered planner either is in violation of the law, is not in the business of giving advice about securities, or is providing that advice solely incidental to the practice of another profession, such as accounting.

2. You can also check with your state securities agency to find out if your planner is licensed to sell securities. Similarly, your state insurance commission may be able to tell you whether the individual is licensed to sell insurance. If your planner is claiming to be fee-only but also is licensed to sell products, you need an explanation. While some fee-only planners may keep their licenses for potential future use or other reasons, you should definitely check out this discrepancy.

3. If your planner is, or ever has been, licensed to sell securities, you should ask your state securities agency for a copy of his or her Central Registration Depository (CRD) file. CRD files contain information about complaints, lawsuits, and regulatory penalties. You should think twice about working with a planner who has even one serious blemish on his or her record--- such as churning, unauthorized trades, or unsuitable recommendations--- or a whole series of more minor infractions or pending complaints.

The Securities and Exchange Commission (SEC)

If your planner is not registered at the state level, it may be because the firm has more than $25 million in assets under management and is required instead to register with the SEC. You can call the SEC at 202-942-8088 to check on the firm's registration status. To get a copy of an ADV form, phone 202-551-8090. To check on the disciplinary history of your advisor, log on to the SEC website at http://www.sec.gov.

The ADV Form

When investment advisers register with the SEC or the state, they are required to fill out a form describing how they conduct their business. They are also required to provide potential clients with Part II of this document, the ADV form, or with a brochure containing the same information. When selecting a financial planner, you should always request a copy of Part II of their ADV form, rather than the brochure, since it spells out the important information in a relatively easy-to-follow question and answer format.

In examining the ADV form for compensation information, the best place to start is with Question1C. Has the advisor checked off commissions as a source of compensation? If so, you are not dealing with a fee-only financial planner. However, many fee-and-commission planners do not check this box, so you will probably have to look further for relevant information. This is most likely to be found in Schedule F, where the advisor explains his or her answers to questions on the form. Pay particular attention to explanations of Questions 7, 8, 9, and 13, which cover "Other Business Activities," " Other Financial Industry Activities or Affiliations," " Participation or Interest in Client Transactions," and " Additional Compensation." If you read in Schedule F that "the firm is fee-only, but employees of the firm also earn commissions as insurance agents or registered representatives of a brokerage firm," don't be fooled. You are dealing with a fee-and-commission planner, and one who is guilty of misleading disclosure at that. You should also be on the lookout for information that the advisory firm conducts most of its transactions through an affiliated broker-dealer or insurance broker. Such affiliations are another sign you may be dealing with a fee-and-commission planner.

In examining the ADV form, be aware that the SEC and states do little to check the accuracy of the information provided. You may want to check out some of the easier-to-verify information, such as education or credentials, yourself.

The National Association of Personal Financial Advisors (NAPFA)

Many fee-only financial planners are members of the National Association of Personal Financial Advisors. For a list of the fee-only financial planners in your area, you can call NAPFA at 1-800-366-2732. You can get the same information by visiting the NAPFA homepage on the World Wide Web at http://www.napfa.org .

Interviewing your planner

Once you have checked out the official records about your prospective planner, you still need to sit down with him or her and ask direct questions that zero in on the issues of competency, experience, working style, compatibility, and compensation. The following are among the questions CFA and NICE encourage you to ask:

How long have you been in business?

Look for an advisor who has at least three to five years of experience as a financial planner, including experience dealing with clients whose situations are similar to yours. It is generally a good idea to work with a planner who has been in the community long enough to provide you with reliable references from friends, business colleagues, and other financial professionals.

What is your professional background?

Look for a strong educational and job experience background covering the basics of financial planning and continuing education to update the planner's knowledge.

Will you provide a detailed explanation of how you are compensated?

You may want to ask your planner to review with you the specific parts of the ADV form that deal with compensation. Be sure to ask specific questions, such as whether the planner earns income from any sources other than directly from clients, or whether he or she earns commissions or accepts other special incentives. If the planner does, ask how he or she handles the conflicts of interest that arise and whether he or she is willing to disclose the actual amount expected to be earned in association with specific recommendations made. If the planner charges fees, ask how those fees are set. If he or she uses an hourly fee, ask for an estimate of how long the process will take.

How do you develop your recommendations?

The process of developing a financial plan takes time. Your planner should be willing, at the outset, to help you discuss and define your financial goals, should develop a detailed understanding of your current financial situation, and should learn how you feel about taking risks with your money. Be very wary of a planner who does not go through this process before making recommendations.

Will you provide references from an objective list of clients?

In particular, ask for a list of references who have been with the planner for at least two years and whose personal situation is similar to yours. Furthermore, ask the planner to disclose the objective criteria used to determine which clients were included on the list. This will help prevent the planner from selecting only his happiest clients as references. You could then randomly ask at least three of these clients about their level of satisfaction with the planner, what they like best and what they like least about the planner, how well they have done in making progress toward their goals, and whether they intend to continue as clients of the planner. Some planners may be reluctant to provide client references out of respect for their clients' privacy. In these cases, it is a particularly good idea to request references from other financial professionals in the community.

A final note:

If this seems like a lot of work, that's because it is. But remember, it's your financial future. You are the one who has to live with the results… as well as pay for any mistakes. Taking the time at the outset to find a competent, honest, objective financial advisor could save you and your family a lot of financial pain in the long run.

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Consumer Federation of America (http://www.consumerfed.org) is a non-profit association of approximately 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education.