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ELDER INVESTMENTS: A CRITIQUE OF PROFESSIONAL AND CONSUMER MEDIOCRITY

Errold F. Moody Jr.*

The elderly continue to face an alarmingly high level of fraud and unprofessional behavior by numerous advisors and salespeople within the securities, insurance, and financial planning industries. The situation shows no signs of improving, in part because of the poor training of governmental licensees and proliferation of secondary licenses and titles used by investment, insurance, and planning "professionals" to earn the trust of the elderly. The services provided by the titleholder are often complex, difficult for people to understand, completely misunderstood, or simply fabricated. They are used to encourage elders to invest their money in ways unsuitable to their best interests.[1] Evidence of the complexity of the problem

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1. Financial Industry Regulatory Authority (FINRA), *Investors' Best Practices: Common Investor Problems and How to Avoid Them*, http://www.finra.org/Investors/

can be found in the requirements to obtain these licenses, designations, and titles. Unfortunately, these licenses and various designations and titles do not demand that individual licensees necessarily understand the fundamentals of investing.[2] Further, most are not subject to government oversight or regulation.[3] Industry licenses and designations - supposedly portraying knowledge and competence - abound, but only a couple are worthy of consideration. Because the industry does not require a fundamental knowledge base to obtain a financial planning designation, planner incompetence can make it impossible for the consumer to understand the investment process and, as a result, millions of dollars of consumer money are lost each year because the supposed experts marketing these products lack an understanding of their features and nuances.[4] Or, they simply don't care to find out.

That said, most consumers undertake little effort to reasonably review their financial service purchases. More often, the primary focus for the selection of an advisor is based on the establishment of a personal relationship that has nothing to do with financial competency.[5] Most notable are looks, golf game, and similar religions. Consumers, perhaps particularly older people on limited budgets, are particularly susceptible to solicitations offering free giveaways or food seminars.[6] As a result, thousands of the elderly "invested" millions of dollars for debatable products primarily in exchange for dead chickens. It is absolutely tacky, but true.

In an effort to protect senior investors, the states and the

ProtectYourself/BeforeYouInvest/AvoidCommonInvestorProblems/index.htm (last visited Nov. 21, 2008).

2. On fundamentals of risk, diversification, etc., *see* especially *infra* notes 107-119 and accompanying text.

3. *See* John A. Gray, *Reforms to Improve Client Protection and Compensation Against Personal Financial Planners' Unethical Business Practices*, 32 AM. BUS. L.J. 245, 254 (1994) [*Reforms to Improve*].

4. *See Reforms to Improve*, *supra* note 3, at 253-55.

5. *See* FINRA, *Senior Fraud Risk Survey*, www.finra.org/web/groups/Investors/@inv/@smart/documents/Investors/P036813.pdf (last visited Nov. 21, 2008).

6. *Id.*

federal government subsequently began to monitor the practices of advisors who exercise these free lunches.[7] But such effort is well after the fact; the financial damage has been done. More importantly, psychological damage has been done when susceptible people recognize they have been duped. And the older people typically are even more disinclined to pursue other, more appropriate, financing packages that their expanding budgets and limited resources would warrant. Given such real life emotion, along with current lax or nil oversight by either governmental or professional organizations of unsuitable activity, the investor will not be protected from unknowledgeable or unscrupulous agents.

Critics may initially feel that this commentary is controversial or off-base considering the millions of dollars spent by the Securities Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA), North American Securities Administrators Association (NASAA), Department of Labor (DOL) and every state insurance department to offer supposed guidance, making sure that investments of any type will be ***suitable*** given the needs and circumstances of the individual investor.[8] Millions are spent in licensing training for thousands who enter the business each year, yet there is no training on suitability.[9] When the current system fails, millions more are spent in arbitrations, mediations, and lawsuits to address the failed suitability of the approved investments.[10]

This article asserts that investor problems are caused primarily by one major issue – lack of knowledge. Knowledge is woefully nonexistent at all levels in American financing,

7. Securities Exchange Commission, *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars*, at 2, www.sec.gov/spotlight/seniors/freelunchreport.pdf (last visited Nov. 21, 2008).

8. *See* John A. Gray, *Personal Liability Exposure of Financial Planners: Private Enforcement*, 36 ST. LOUIS U. L.J. 623, 630-31 (1991-1992) [Gray].

9. *See* Susan K. Foster, *Financial Planning: Is It Time for a Self-Regulatory Organization?*, 53 BROOK. L. REV. 143, 143, 149 (1987-1988).

10. *See* FINRA, *Dispute Resolution Statistics*, http://www.finra.org/Arbitration Mediation/AboutFINRADR/Statistics/index.htm (showing that 21.5% of arbitration cases were the result of disputes over unsuitability) (last visited Nov. 21, 2008).

investing, and retirement planning.[11] This article examines the various recent systemic failures that demonstrate how lack of knowledge, along with forces and incentives, continue to promote system failure despite its grievous impact on individuals, especially the elderly who rely on their investments for income when they can no longer work. The first section of this article reviews the knowledge required to qualify for various levels of individual licensing. The second section of this article provides an overview of the financial products available in the market and attempts to analyze where the failures in investor knowledge are most apparent.

LICENSING OF INDIVIDUALS TO SELL AND ADVISE

With the following education, individuals can hold licenses to advise the public and other licensed individuals regarding investments and other products.

THE SERIES 7 GENERAL SECURITIES LICENSE

This is licensing for general securities registered representatives, including most stockbrokers.[12] The Series 7 securities license concentrates study of various elements of stocks and bonds, leading to a six-hour qualifying exam.[13] This license represents *less* than one college course on finance. While the course materials cover some investment fundamentals, other important fundamentals are not covered, such as alpha, beta, correlation, diversification, asset allocation, standard deviation, Monte Carlo, and more.[14] Instruction covers what material the student is tested on, but not what is needed for real life application. Continuing education was mandated in the early 1990s, but none of it demands knowledge of the fundamentals

11. *See* Gray, *supra* note 8, at 629.

12. *See* FINRA, *Content Outline for the General Securities Registered Representative Examination (Series 7)*, 1, http://www.finra.org/web/groups/corp_comm/documents/home_page/p038201.pdf (last visited Nov. 21, 2008).

13. *See id.*

14. *See generally id.* (failing to cover the latter three terms).

either.[15]

For example, no instruction for the use of a financial calculator is mandated.[16] Basic mastery of a financial calculator is imperative. Such a calculator can calculate present and future value. For example, it can tell you what a value of an asset will be in the future given the time and return, or what an asset to be received in the future might be worth now given the same particulars and an assumed inflation rate. Admittedly, there are preprogrammed computer software programs that can do the basics, but the personal capability with such a calculator allows personalized input for a particular investor. If an advisor cannot even use a financial calculator, it is impossible for that advisor to discuss money or how it works. FINRA is the largest independent regulator for all securities firms doing business in the United States and oversee nearly 5,000 brokerage firms, 175,000 branch offices and 680,000 registered securities representatives.[17] None has ever had any financial calculator training during securities licensing training. Due to this unbelievable "oversight," it is debatable if FINRA officers can use one. I think not.

Further, very little formal guidelines exist for suitability to match investment and investor. Diversification, by the numbers, is not even touched upon. An advisor who does not understand diversification cannot understand risk, and therefore cannot understand suitability. Hence, they should not be used except with extreme skepticism or for very specific purposes.

As author Rick Ferri noted,

> In this surreal world of investment advice, anyone can claim to be an expert and get paid for it. This is why most stockbrokers, financial planners, and insurance

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15. *See* American Investment Training, *FINRA NASD CE* for *Firm Element*, http://www.aitraining.com/firmelementce.htm (last visited Nov. 21, 2008).

16. *See* Financial Calculators – KJE Computer Solutions, LLC website, *Basic Financial Calculator*, http://www.dinkytown.net/java/FinCalc3.html#defn (last visited Nov. 21, 2008) (The "basic financial calculator works just like a pocket financial calculator. In addition to the normal calculator arithmetic it can also calculate present value, future value, payments, or number of periods.").

17. FINRA, www.finra.org/index.htm (last visited Jan. 6, 2009).

> agents are in the business, and why accountants, attorneys, and bankers want in as well. The problem is, most investment advisors are borderline incompetent. Thousands of them lack the basic investment skills and knowledge of a first-year business student.[18]

Pundits may raise a hew and cry regarding such comments. But then, how could Lehman, Merrill, et al., go down the tubes if risk and suitability were formally taught and understood?

SERIES 24 GENERAL SECURITIES PRINCIPAL LICENSE

This license is for those who supervise the activities of other agents, generally Series 7 brokers.[19] Topics that are tested include Supervision of Investment Banking, Trading Market Supervision, Sales Supervision, Primary and Secondary Markets, Investment Companies, and Supervising Customer Accounts and Orders.[20] But nothing on the application of products.

Most licenses in the securities industry fall in the above two categories. In each case the dominant focus for consumer protection – a complete understanding of suitability – is noticeable by its inadequacy. For each of these licenses, while the suitability of investments is covered to a small degree, there is insufficient training to formally protect consumers.

INSURANCE SALES LICENSE

All states now require that individuals obtain a license in order to sell life insurance.[21] However, the coursework requirements can vary greatly between states from mandated formal instruction in a classroom. California, for example, requires thirty-two hours of training, including twelve hours on

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18. RICHARD A. FERRI, PROTECTING YOUR WEALTH IN GOOD TIMES AND BAD, 84 (McGraw-Hill) (2003).

19. American Investment Training, *Series 24 License,* http://www.aitraining.com/series24.htm (last visited Nov. 21, 2008).

20. *Id.*

21. U.S. BUREAU OF LABOR STATISTICS, OCCUPATIONAL OUTLOOK HANDBOOK, 2 (2008-2009 Ed.), http://www.bls.gov/oco/ocos118.htm#training (last visited Nov. 21, 2008) (Insurance Sales Agents section).

ethics, and Alabama requires a mere twenty hours of training.[22] Other states, such as Idaho and Arizona, have no formal classroom instruction.[23]

There is a valid reason why the consumer has a negative impression of insurance salespeople. Forgetting the incentives of commissions to sell regardless of suitability, the background instruction is abysmal. Even California, with its thirty-two hour life insurance only course, which is more extensive than any other state at this time, fails to demand a review of product suitability.[24] There is no mandatory instruction for the use of a financial calculator, as described above. There is nothing on an analysis of policy illustration explaining, supposedly, how the policy will work over time. This training is critical since it is used in almost any sales attempt. It is also a main element in complaints and law suits because it can be manipulated in various--almost indecipherable--methods. It can only be hoped that the financial advisor learns these skills. However, the author has not found this to occur.

In addition to this lack of training, there is the almost exponential increase in product types including variable annuities, life insurance, equity indexed funds, and every type of combination one can imagine. Few advisors, let alone customers, are able to understand all of these product types. For example, as a person with experience in the field, the author knows agents should also be familiar with Stranger Owned Life Insurance and Viatical Settlements. However, even the most stringent state licensing instruction requirement, like California, covers none of these in detail, if at all.[25] This is problematic given that sellers need to fully understand these products in order to effectively utilize them for customers. Therefore, many

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22. *Id.*

23. *See id.*; California Department of Insurance, *Agents & Brokers: How Can I Get a License?*, http://www.insurance.ca.gov/0200-industry/0050-renew-license/0200-requirements/personal-lines/how.cfm (last visited Nov. 21, 2008).

24. *See id.* (failing to mention product suitability as being one of the educational objectives).

25. *See id.* (failing to mention Stranger Owned Life Insurance or Viatical Settlements in the educational objectives).

agents are decidedly poorly trained to advise consumers because they are unfamiliar with the products they are selling. To compensate for this lack of knowledge, they distribute whatever information and marketing material that they might receive from the life company or an insurance agency, and this marketing collateral is primarily designed to sell the product. The author does note that various caveats are offered in some marketing collateral and within the formal contracts, yet there is hardly any person, including insurance staff and officers, who truly understand the implications of the rhetoric. Consumers do not read the contract. For the few that might attempt it, without an insurance background, they will not understand it.

Nevertheless, if one is seeking insurance, the only way an individual can get information on such products is by consulting with a licensed agent.[26] There is no service that provides information or critiques about the innumerable policies for consumers. The insurance companies only send the information to agents via mailing and e-mail lists purchased from state insurance departments.[27] As a result, consulting a licensed insurance sales agent is the best and probably only way to get the most current information on the products.[28]

CERTIFIED FINANCIAL PLANNER (CFP) LICENSE 13

The CFP license is the most common financial advisor designation in the United States.[29] Note that this is NOT a formal license by any governmental entity--merely a designation bestowed by the CFP Board of Standards if certain criteria have been met. The training covers seven courses that include: General Principles of Financial Planning, Insurance Planning

26. *See* U.S. BUREAU OF LABOR STATISTICS, *supra* note 21.

27. *See id.*

28. CPAs and attorneys, including estate-planning attorneys, do not have access to this material. While professionals may want and need it, they cannot get it unless they are licensed as described above.

29. George Steven Swan, *The Law and Economics of Interprofessional Frontier Skirmishing: Financial Planning Association v. Securities and Exchange Commission*, 16 U. MIAMI BUS. L. REV. 75, 96 (2007).

and Risk Management, Employee Benefits Planning, Investment Planning, Income Tax Planning, Retirement Planning, and Estate Planning.[30] The CFP courses encompass about one semester of college work. Some students will attend a formal classroom, though it is not necessary to prepare for the exam, as a student can take the courses via self-study.[31]

Under guidelines enacted in 2007, new licensees are required to pass a ten-hour exam.[32] As of March 1, 2007, a new licensee is also required to have a college degree.[33] However, the degree can be in any discipline.[34] Licensees are required to have three years of experience before they are permitted to provide financial planning to customers.[35]

This designation is highly marketed and coveted because of the supposed ability to do comprehensive planning for the consumer.[36] The problem becomes that the consumer reasonably perceives that the licensee will offer sophisticated planning, but basic requirements do not provide the knowledge to make that expectation realistic. For instance, when the author got the designation in 1984, he found that the material *did* provide insight into many areas that would not have been identified through any other licensing curriculum. The caveat was that the material did *not* make one very astute or knowledgeable in the complicated and immense subject matter.

A review of course material shows that not much has

30. Certified Financial Planner Board of Standards, Inc., *The Education Requirement Guide to CFP Certification*, http://www.cfp.net/become/education.asp (last visited Nov. 21, 2008) [hereinafter *The Education Requirement*].

31. *Id.*

32. *Id.*; Certified Financial Planner Board of Standards, Inc., *Topic List for CFP Certification Examination: Schedules and Deadlines*, http://www.cfp.net/downloads/Financial%20Planning%20Topics%202006.pdf (last visited Oct. 30, 2008).

33. *Id.*; *The Education Requirement*, *supra* note 30.

34. *Id.*

35. *Id.*, Certified Financial Planner Board of Standards, Inc., *Work Experience Guide to CFP Certification: Work Experience Standards*, http://www.cfp.net/become/work.asp (last visited Oct. 30, 2008).

36. *See Work Experience Guide to CFP Certification*, *supra* note 35; Certified Financial Planner Board of Standards, Inc., *Guide to CFP Certification*, http://www.cfp.net/become/certification.asp (last visited Nov. 21, 2008) [hereinafter *Guide to CFP Certification*].

changed since the author completed the course in 1984. For example, the material still does not adequately demonstrate risk (though little was statistically notable or available in 1984). Statements from a CFP "graduate" in 2004 indicated that diversification was not taught. The Brinson Beebower review offers asset allocation modeling but with the wrong focus.[37] Also problematic is that none of the models is complete or applied to actual situations. There is no material regarding the odds of loss (addressed below). In other words, without a definitive study of each area of financial planning, and without applying this information to real-life scenarios by professionals, there is nothing to guarantee that students will come away with competent and thorough planning expertise. The author notes that some instructors and material may try to offer real life examples, but a one-semester orientation to planning in no way indicates comprehensiveness nor competency by the instructor.

Finally, another critical area of study to consider is insurance. It is well-known in the industry that this section of CFP study is inherently weak. The CFP exam does not cover the material as inclusively as the licensing exam for California (the only state the author can comment on directly), or as inclusively as the Life and Disability Insurance Analyst exam.[38] However, despite these problems, one positive note is that, unlike some of the other licensing requirements, the CFP instruction exam requires the ability to use a financial calculator, which at least ensures that CFPs will possess a minimum level of competency in this area.[39]

37. Richard Newell, *The Importance of Asset Allocation*, http://www.richardnewell.com/asset-allocation.htm (last visited Nov. 23, 2008).

38. This author took and passed the exam - and that exam had effectively nothing to do with the knowledge base provided by my CFP study. I would never suggest a CFP for insurance advice, because it is just not very strong.

39. *See* Certified Financial Planner Board of Standards, Inc., *CFP Certification Examination: Guide to CFP Certification: What to Bring to the Exam*, http://www.cfp.net/become/exam.asp (last visited Nov. 21, 2008).

CHARTERED FINANCIAL ANALYST (CFA) LICENSE

Individuals who possess this designation focus almost exclusively on investing and minimally on financial planning.[40] Individuals with CFA licenses must go through a highly disciplined and intense study of investing with a major focus on stocks, bonds, and portfolio management.[41] While the public might be well advised to use these licensees, they almost always work for institutions rather than individuals.[42]

OTHER FINANCIAL ADVISOR DESIGNATIONS

In addition to the designations discussed above, there are over one hundred other financial service designations offered to the public, and more are being added each year.[43] For example, there are also licenses to be a Chartered Financial Consultant (ChFC), an Accredited Personal Financial Specialist (APFS), and a Chartered Investment Counselor (CIC), to name a few.[44] Although these various designations may focus on some areas that might assist consumers with their financial planning, due to the limited scope, and generally limited instruction required to obtain them, consumers should not consult with any individual licensees without doing some personal research into the licensee's individual background and knowledge.[45] Generally, the same elements not covered in the CFP instruction are missing from instruction for these designations. However, the ChFC is heavily grounded in, and focuses on, insurance education. But the author has found that the focus is designed to sell life insurance, for its "ability" to solve most financial

40. *See* Rick Wayman, *What Does "CFA" Mean?*, http://www.investopedia.com/articles/analyst/060302.asp (last visited Nov. 23, 2008.)

41. *See id.*

42. *See* U.S. BUREAU OF LABOR STATISTICS, *supra* note 21, *Financial Analysts and Personal Financial Advisors*, http://www.bls.gov/oco/ocos259.htm (last visited Nov. 23, 2008).

43. *See* Swan, *supra* note 29, at 95.

44. *See* Gray, *supra* note 8, at 630.

45. *See* Swan, *supra* note 29, at 95.

problems. That simply is untrue.

The National Association of Personal Financial Advisors (NAPFA) is a national organization promoting comprehensive fee planning. It also touts its "highest standards for professional competency, comprehensive financial planning, and fee-only compensation."[46] There are over 200 members in California.[47] In the mid 1990s the author took them to task for violating state law. An officer replied, "We always knew what the law was, we just figured we'd never get caught, and if we did, we'd simply get the law changed." The law remains intact--further necessitating the following statement in 1998 from a meeting by the State Department of Insurance regarding illegal planners:

> Despite some groups' interest in changing current law, there is an existing law which is, and has always been, quite clear. While a financial planner may be illegally engaging in insurance analyst activities and may not be aware of their violations, it is my hope that this explanation of policy will provide them with the impetus to come into compliance or cease the illegal activity immediately. Per insurance code Section 1844, any person who acts, offers to act, assumes to act, as a life and disability insurance analyst when not licensed by the commissioner per this article . . . is guilty of a misdemeanor. Consistent with current practice, information obtained on individuals in noncompliance will be aggressively pursued.[48]

No NAPFA member has ever complied with the law. Nor has any other impacted membership (Financial Planning Association, California CPA Society, American Institute of CPAs, CFP Board of Standards, College for Financial Planning). It was expected that the organizations would comply.[49] The state simply did not have the manpower or money to pursue

46. The National Association of Personal Financial Advisors, http://www.napfa.org (last visited Jan. 6, 2009).

47. The National Association of Personal Financial Advisors, http://findanadvisor.napfa.org/Home.aspx/Search (last visited Jan. 6, 2009).

48. Letter from Jeffrey Kenny, Assistant Ombudsman & Legislative Liaison, *available at* http://www.efmoody.com/cdi.html (last visited Jan. 6, 2009).

49. Interview with John Garamendi, State Insurance Commissioner, 2000.

widespread noncompliance. But no matter the lack of enforcement, one cannot actively violate the law and still be a fiduciary. This transgression speaks volumes about the industry overall.

One secondary designation--highly marketed and accepted by many elderly--(of particular interest) is the Certified Senior Advisor, which can be earned with only three days of coursework.[50] The curriculum is so highly focused on marketing that a few broker dealer firms refuse to let their agents use the 'designation' in any advertising, including business cards. The idea that a few days of 'study' makes one able to grasp what is needed to address the complex financial needs of the elderly, or anyone for that matter, is ludicrous. The same was true for the Certified Retirement Financial Advisor, which also required just three days of training.[51] Even though the organization is defunct, it still impressed thousands of seniors enough for them to invest millions of dollars with inept advisors. The seniors assumed that the government agencies would scrutinize the designations beforehand to assure viability. However, government scrutiny has not entered the scene until recently, but only after too many elderly lost their financial reserves.[52]

Starting in the early 1990s, the securities industry instituted requirements for continuing education.[53] Most states require that insurance sales agents take continuing education courses, but the number of hours required varies significantly from state

50. Mark Cussen, *Certified Senior Designations Under Scrutiny*, http://www.investopedia.com/articles/professionaleducation/07/seniors.asp (last visited Nov. 21, 2008).

51. Certified Retirement Financial Advisor, *Financial Planners Target Retirees: The "Senior" Credentials*, http://www.crfa.us/press/kiplinger.html (last visited Nov. 21, 2008).

52. *See* Cussen, *supra* note 50. In comparing the licenses, it is notable that while the CFP and ChFC are limited in depth, they are far better licenses for advising individuals than a securities broker license because the curriculum reviews various activities beyond the nature and scope of investments. The least useful element for CFPs is insurance advice for the reasons described above and because the instruction in that area is way behind the times (and has been identified by CFP officers as needing a complete update).

53. *See* FINRA, *Continuing Education*, http://www.finra.org/Industry/Compliance/ContinuingEducation/index.htm (last visited Nov. 21, 2008).

to state.[54] Neither license requires additional study of the real value of money, the study of risk, or understanding policy illustrations. While a competent instructor may indeed provide critical information, it is neither mandated nor universal. Additionally, there is no requirement for a diversity of continuing education. One can continually take courses relating to the same topic, which is commonly investments, for each required reporting period. For example, CFPs are required to report thirty hours every two years and many take the same focus – generally investments – each required reporting period.[55] The continuing education is necessary to keep advisors sharp, but its usefulness all depends on what courses advisors are taking and whether they are only trying to cover the mandatory hours with minimum effort. After all, thirty hours required every two years is not much considering the multitude of new financial products entering the market each year. For example, where were the independent critiques on auction securities or the underlying derivatives for mortgages? Was there any separate professional instruction of index annuities or life insurance? No. And I do not think it would have done any good to provide them in any case because: 1) most advisors think they are truly "sharp" at understanding a product even given only a single college course or a single semester on money and would not attend a paid seminar, and 2) such training and supposed recognition would only slow sales or services--so that generally precludes any effort at true competency.

FORMAL EDUCATION AS QUALIFICATION FOR FINANCIAL ADVISORS

Post-secondary academic work generally provides advisors with a body of knowledge that imperfectly serves the needs of individuals, especially seniors, seeking financial planning advice.

54. *See* U.S. BUREAU OF LABOR STATISTICS, *supra* note 21.

55. *See Guide to CFP Certification, supra* note 36.

LAW

Many attorneys lack knowledge of the basics of investments, insurance, or other disciplines within financial planning.[56] Law curriculum classes in estate planning, real estate, and benefits are electives and, by themselves, provide an inadequate basis for appropriate investing advice.[57] Furthermore, fundamental insurance information is missing from law school estate planning curriculum.[58] The general consensus of true planning professionals is that the bulk of insurance in Irrevocable Life Insurance Trusts is the wrong type, and they have not been adequately monitored on an annual basis. One could say that the responsibility for such insurance products was turned over to others who *apparently* had the expertise to implement the policies. Somewhere along the line, attorneys have to recognize that they cannot abdicate such responsibility in a critical area without having some idea of what is supposed to work and who might be able to do it.

Lastly, when doing arbitration work in the past, as well as acting as an expert witness regarding securities, investment, and retirement cases, the author never met an attorney who knew the correct definition of diversification. That is problematic because not knowing the formal definition can be detrimental to a client's case, let alone their portfolio. An attorney cannot justifiably take this type of case to arbitration or trial without at least a basic understanding of investing principles. (Note--they may still be successful in achieving funds for the client, but the case would be based on secondary issues.) Further, recognize that attorneys addressing the risks of money without the use of a

56. *See* George Steven Swan, *Legal Education and Financial Planning: Preparation for the Multidisciplinary Practice Future*, 23 CAMPBELL L. REV. 1, 19 (2000).

57. For example, none of these courses typically require knowledge of the use of a financial calculator, which is essential for an estate planner to determine the present and future value of monies.

58. *See* Stanford Law School website, *Estate Planning Description*, http://www.law.stanford.edu/program/courses/details/292/Estate%20Planning (last visited Nov. 21, 2008) (failing to mention insurance as being a topic covered in the course).

financial calculator are taking a large risk in breaching their fiduciary duty. Admittedly, they may rely on experts, but most are not versed with a financial calculator either and their opinions should be subject to intense scrutiny as well. This is called "defective referral," using others without a formal scrutiny of competency.

The author recently was engaged to review a variable insurance product. The plaintiffs used a consultant barred by the NASD/FINRA and had only an insurance license. Ludicrous, but neither side had done any homework on the background.

DEGREES IN FINANCIAL PLANNING

The American College, an institution devoted to banking and financial education located in eastern Pennsylvania, instituted the first Master's program in Financial Planning.[59] The College for Financial Planning, founded in 1972 and located in Colorado, was founded shortly thereafter.[60] Now many universities, in every major city throughout the United States, offer related Bachelor's and Master's degree programs. Graduates of these programs have the most knowledge to offer consumers. The curriculum is far more comprehensive than anything offered by the CFP courses. In the author's personal experience, the Master's program of study was at least 75% more intensive on the subject areas than any courses offered by the CFP curriculum. In particular, the estate planning coursework, the author's area of expertise, was generally acceptable. However, while the coursework did address the importance of insurance for such planning, business needs, and more, it was clearly inadequate in providing detail in the subject area. Merely stating that insurance was needed did very little to indicate how to decipher what type was truly necessary and

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59. *See* Robert W. Cooper & C. Bruce Worsham, *Foundations of Financial Planning: An Overview, in* THE FINANCIAL PLANNING PROCESS, 1-29, (C.B. Worsham, ed., The American College) (2004).

60. *See id.*

how it would work. The author tried some of their electives hoping to get the insight needed and found that none existed. The situation has not changed. Recent articles by estate planning attorneys still do not provide any detail on insurance products or application.

UPDATING FORMAL EDUCATION

While the foundation of knowledge obtained at a university is far greater, and probably motivates a licensee to learn more after the degree, the knowledge taught becomes severely outdated at lightning speed because the economics in the world are constantly changing. Products come to market that were, only a few months previously, never envisioned.[61] The tax rates change, the tax laws change, the politicians change, only to change again in rapid succession; all the while the market explodes with entities using new exotic products put forth by investment and insurance companies fighting for business. For example, take the drastic growth in the mutual fund industry. In the beginning of the 1950s, there were one hundred funds available for investment.[62] Now, there are over 10,000 available funds.[63]

Advisors rightly state that they cannot know everything and often refer clients to other experts as necessary. However, this practice requires that the advisor diagnose the problem correctly and then choose someone who has adequate skills to address it. For example, referring a client to an estate planning attorney for an Irrevocable Life Insurance Trust (ILIT) only reflects that the trust's legal structure is correct, not the underlying product in it. As a result, many elderly have effected an ILIT that is subject to failure.

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61. Examples include exchange-traded funds, indexed annuities, no lapse insurance, and all of the Collateralized Mortgage Obligations that caused the latest credit debacle.

62. Jim McWhinney, *A Brief History of the Mutual Fund*, http://www.investopedia.com/articles/mutualfund/05/MFhistory.asp?Page=2 (last visited Nov. 21, 2008).

63. *Id.*

Accordingly, continuing education is valid, but generally insufficient and inadequate. The problem is that many of the courses are nothing more than a rehash of old material that often lacks updates. Nonetheless, many brokers and planners continue to take such courses, because they are easy and inexpensive. There are excellent courses available, but they tend to be geared towards investing and are expensive. Additionally, the use of more sophisticated offerings may simply confuse attendees who have limited backgrounds.

These facts dissuade brokers and planners from participating in the more informative courses, especially if they are looking to cheaply satisfy their continuing education requirements.

FIDUCIARY DUTY IN FINANCIAL PLANNING

The financial advisor's duty is defined by tort and contract law, and ethical oversight by professional licensing boards.

LEGAL LIABILITY

As with all professionals, a financial planner has a legal obligation to provide services that meet the standard of care for each individual client.[64] In negligence, generally, the standard of care is whether the respondent behaved as an ordinary, reasonable, prudent person would have behaved under the circumstances.[65] The professional financial planner, or one simply presenting him or herself as such, however, has the additional obligation to use any special knowledge he may have obtained through education, training, or experience.[66] Further, the law may impute a certain level of skill and knowledge regardless of the facts when determining the standard of minimum professionally acceptable conduct.[67] The problem is

64. *See* Gray, *supra* note 8, at 636.
65. *See* Cordas v. Peerless Transp. Co., 27 N.Y.S.2d 198, 200 (1941).
66. *See* Gray, *supra* note 8, at 630.
67. *See id.* at 638.

that while the law may impute a level of care, who is to acknowledge what care was *supposed to be provided?* That is the crux of most litigation, though rarely pursued correctly because the attorneys, participants, judges, or experts have little or no knowledge of proper application of the products. There are certain experts that can address the theory of investments, very few that can address insurance or annuity application adequately, and almost nil who can do all, certainly as the products address real life. Theory and application may be diametrically opposed.

As discussed previously, the knowledge requirements for obtaining a financial advisor designation are not highly regulated.[68] Therefore, the greatest likelihood of legal liability lies in the violation of fiduciary duty, the legal requirement that an advisor put the client's interest first and act always with the best interest of the client in mind.[69] However, this is not the case with insurance agents, who owe their initial allegiance to the employer insurance company.[70] Trust officers are also held to a higher level of responsibility, but some trust companies attempt to reduce exposure by including in the contract an exculpatory clause in which they hold themselves accountable only for what a prudent, but inexperienced man, would do.[71] However, that still does not exclude them from acting recklessly, in bad faith, or willfully breaching their fiduciary duty to the trust beneficiaries.[72]

The CFP Board of Standards has only recently enacted a fiduciary duty requirement and enforcement of these standards became effective January 1, 2009.[73] No matter--the CFP Board

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68. *See* Swan, *supra* note 29, at 95.

69. *See* Gray, *supra* note 8, at 637.

70. *See* Gregory Boop, *Insurance Agents vs. Insurance Brokers*, http:// businessinsure.about.com/od/agentsandbrokers/a/agentnbroker.htm (last visited Nov. 21, 2008).

71. FED. DEPOSIT INS. CORP., TRUST EXAMINATION MANUAL, http://www.fdic .gov/regulations/examinations/trustmanual/section_4/section_iv.html#iv_d (last visited Nov. 5, 2008).

72. *See id.*

73. Certified Financial Planner Board of Standards, Inc., *Focus on Ethics: Raised*

has directly stated that it will not enforce an ethical violation unless preceded by a legal one.[74] The Board's stated rationale for refusal to enforce ethics was that it was very concerned (rightfully so) about subsequent financial liability if sued by a CFP on purely ethical grounds.[75]

With regard to professional ethics standards, the Rules of Fair Practice established by the NASD/FINRA state that a broker has breached his or her duty if a broker "recommends speculative securities without finding the customer's financial situation and being assured that the customer can bear the risk."[76] This seems to be the crux of the problem identified in most arbitrations and lawsuits. The first question to ask is what is a speculative investment: gold, hedge funds, or perhaps some mutual funds? While most experts would not put a standard equity fund in the *speculative* category, it was arguably speculative for a broker to suggest the use of a fund in March 2000 with knowledge of the inverted yield curve. The same can be said about the yield curve in 2006.[77] It is also arguably speculative to use the proverbial stay-the-course ideology as the market lost over 40% thereafter in a three-year period. Late 2008

Standards to be Enforced Beginning January 1, 2009, http://www.cfp.net/certificants/updates.asp#4 (last visited Jan. 6, 2009).

74. *Id.*

75. *Id.*

76. ERROLD F. MOODY, NO NONSENSE FINANCE: E.F. MOODY'S GUIDE TO TAKING COMPLETE CONTROL OF YOUR PERSONAL FINANCES (R.R. Donnelly ed., The McGraw-Hill Companies, Inc.) (2004).

77. The inverted yield preordained the 2000 recession and hardly anyone had a clue. Why? It's not tested, hence it was not taught. The inverted yield curve preordained the 2008 recession and still but a very few had a clue. Why? It's still not taught. Yet it effectively has a 100% record in prognosticating a recession in twelve months. It is pretty simple to understand. Short-term rates--CDs for example--have lower rates than a thirty-year bond. That's because the longer the time frame in holding an investment, the more risk (everything else being equal-rating, corporate, or municipal). But there are times when short-term rates are HIGHER due to an imbalance in the economy. No economy can handle that inversion. It makes no financial sense. Short-term rates must go down or long-term rates must go up. Period. But any action in this correction brings financial pain--universally a recession in twelve months. Now the curve inverted again in 2006, but the down cycle did not happen until 2008. So while it is accurate in the prediction, the timing is not perfect; the length of recession is not indicated nor how bad it all will be. But if no one bothers to address it, the downturn is a surprise.

showed current losses approaching over 40% in just one year even for the basic S&P 500 index.[78]

The troubling requirement is that the agent be ***assured*** the customer can and should bear the risk. The only way this proposition is effectively possible is to have the customer complete a formal budget and project the numbers to determine how much the client needs for the full retirement. That analysis requires the use of financial tools that the planner is often unfamiliar with and untrained to use. Such analysis is mandatory for anyone who is already retired, or who is nearing retirement, with age fifty-five perhaps as a benchmark. It should determine the risk allocation that might be required and the amount that can be risked with such a strategy. An advisor ***cannot*** accept the statement of a client regarding risk. They do not understand the losses that can be sustained with a portfolio of equities or bonds. They cannot use a calculator nor, even if possible, are they aware of the theoretical concepts of risk and the associated calculations.

RULE 2310 OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS (NASD)

> (a) In recommending to a customer to purchase, sell, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.
>
> (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:
>
> (1) the customer's financial status;
>
> (2) the customer's tax status;

78. Fidelity.com, http://personal.fidelity.com/products/funds/mfl_frame.shtml ?315912824 (last visited Jan. 6, 2009).

(3) the customer's investment objectives; and

(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer[79]

Note that the rule references reasonable grounds and suitability on the basis of facts disclosed by the *customer*. What does or can that mean when the broker does not know the fundamentals of investing? As to their financial situation, this is not determinable unless a budget and formal risk scenario is computed. Individual financial needs fall within the same scenario. Investors may need money for college, retirement,or other purposes, but the numbers need to be crunched to determine feasibility of planning tools and financial products. Yet, for a broker who has never been taught to use even the basic financial calculator, such planning is improbable, if not impossible.[80] The rules are helpful, but the focus is on the customer to tell the broker what to do rather than for the broker to advise.[81] The problem with this system is that customers are clueless as to risk and reward, and brokers are not taught how to deal with such issues. A conundrum, to be sure. Comparatively, these skills are not taught to insurance agents either. Even if they were, it would do no good without the ability to use basic financial tools. Financial planners, per se, have no exposure to the criteria or analysis and often simply fail to account for the complexity of their customers' financial affairs.[82]

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79. NASD Conduct Rule 2310, NASD Manual (CCH) (Amended by SR-NASD-95-39 eff. Aug. 20, 1996).

80. For example, a broker will be presented with the following dilemmas daily. The client's financial status is nebulous at best, and can you calculate their income? Net Worth? How are they applied together? Tax status is acceptable, but is a broker sufficiently trained to review 1040s? (No). Customer objectives: growth income, tax deferral, etc. But while a customer may want growth, they need to know the inherent risk.

81. *See* NASD Manual (CCH), *supra* note 79.

82. *See, e.g.*, California Lutheran University website, http://www.callutheran.edu/cif (last visited Jan. 6, 2009) (offering an online Master's program and courses in Financial Planning that would permit an individual to graduate with

REGULATORY OVERSIGHT

Licensees are governed by professional regulatory boards and state agencies that largely respond to consumer complaints.[83] Unfortunately, their involvement is generally well after the fact, and then is not that helpful. For example, the author had a pro bono case in Florida that bounced between various state agencies for eight years, where the CFP agent admitted guilt; the author is still "waiting in line" for them to order an investigation. The CFP Board granted the individual full exoneration even though he agreed to pay a $300,000 settlement to the plaintiffs for selling a life insurance policy to a seventy-five year-old widow that cost more than her annual income.[84] One does need to inform authorities of wrongs, but unless one is generally part of a very large group who has been harmed, formal assistance is hard to come by.

STATE REGISTRATION FOR COMMISSION SALES

There are effectively two ways of offering securities and advice. One way is by commission and the other is by fee. They may involve different agencies and certainly different guidelines.

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a Master's degree in financial planning without any analytical or customer training. There are about 1,000,000 financial planners per Lutheran College's website that likely have these or worse credentials).

83. *See* George Steven Swan, *The Political Economy of Professional Regulation: Ibanez v. Florida Department of Business and Professional Regulation, Board of Accountancy*, 19 J. LEGAL PROF. 121, 134 (1994), *quoting* THE REPORT OF U.S. REPRESENTATIVE MOORHEAD TO THE HOUSE OF REPRESENTATIVES, 139 Cong. Rec. H2216-H2217 (daily ed. May 4, 1993) (Statement of Rep. Moorhead).

> Financial planning regulation is the weak underbelly of the financial services community. . . . The inadequacy of financial planning regulation is a national problem, and it is time that we recognized that it is a congressional concern. Many of the State legislatures have addressed the issue of who is a financial planner and what is the appropriate regulation of the industry. Most are satisfied their investment advisor acts provide an adequate regulatory framework. But not even the largest States have the budget and manpower resources to enforce a comprehensive scheme of regulation of the large number of independent financial planners.

84. Based on the author's personal knowledge of the case.

If an agent wishes to do business and receive commissions only, they have to have a Securities license for equities as well as an insurance license for the insurance-related products, such as life insurance and annuities.[85] A broker needs to meet the requirements of the Securities and Exchange Commission (SEC) and must have an agreement with a securities organization (B/D or broker dealer firm) in order to transact securities business.[86] An insurance licensee will have many individual contracts with separate companies. Each insurance transaction is conducted through an agreement directly with the company.[87] The issue for the consumer is the potential for abuse with the sale of a product primarily for the benefit of the commissioned agent.

Commissionable sales are "tainted" because an agent will only be compensated if he makes a sale. While the commissions may have been reduced on stocks and bonds over the years, commissions on insurance products are not as heavily regulated, and can be 100% of the value of the first-year premium. Hence the justifiable concern of a purchaser buying these products is that the products are being offered solely for the large remuneration and not as the best financial instrument for the customer. Based on over thirty years of work in the industry, the author's impression is that not all commissions are bad. However, the negative perception is entirely justified, because companies utilize agents with little real knowledge about their products, who do not understand the products suitability for different clients. High commissions on products tend to induce the sale of unnecessary products unsuited to the client's needs. In a recent case, the author noted that a large insurance company not only allowed, but even promoted, the change of an

85. *See* Paul J. Mason et al., *Conference on Life Insurance Company Products: Current Securities, Tax, ERISA, and State Regulatory Issues, Variable Annuity Products in the Bank Market*, C954 ALI-ABA 151, 182-83 (1994) (it is usually not necessary to have both licenses if one wishes to transact business in one field only. Both licenses are necessary for "hybrid" securities such as variable insurance or variable annuities.).

86. *See* Stuart J. Kaswell & Daniele Marchesani, *The ABCs of Broker-Dealer Regulation 2007, Broker-Dealer Regulation - Overview*, 1604 PLI/CORP 9, 11-12 (2007).

87. *Id.*

insurance policy for an ILIT where the commission was over $300,000. It would have been preferable to simply move the old policy over, but that would not have paid effectively anything. The real wrong was that the first policy--for the same amount and the same commission--had been purchased only two years previously. There is an unacceptable surrender penalty of thousands of dollars for the termination of the first policy. The size of these policies may have been unique, but the focus to sell another was not.

A unique element to insurance that is rarely known by consumers is that an insurance company may offer the "same" product but with different commission structures. For example: assume that an annuity is offered at a 5% return with a 4.5% commission. However, the company may also let the agent offer the same annuity with a 4.5% return and a 5% commission. There are no statistics in the industry indicating what is actually happening in the field, but the author would surmise from his experience that the higher commission prevails. This practice is considered legal; however, the ethical justification is debatable at best and it certainly does not pass a fiduciary responsibility analysis. Under a fiduciary premise, the agent must take the lower commission to fulfill his or her duty to the principal/client.

Bonus annuities are almost always a marketing gimmick. With bonuses, a company might offer a first-year bonus of 10% above the general stated return. If the first-year guaranteed underlying return was 5%, the consumer now earns 15% the first year and is highly impressed. However, the bonus ceases after one year, and the company may very well reduce subsequent years' returns to get back the initial bonus, probably more. Most problematic is that the consumer cannot figure this out via the marketing brochure they are given to base their decisions on, because insufficient data is provided up front, and all available data is rarely given even if requested. Equally problematic is that the agent cannot do the number crunching either (no capability with a financial calculator) and simply markets the initial increased return with little to no understanding of its

ultimate future ramifications.

STATE REGISTRATION—FEE FOR ADVICE

Different oversight is required for brokers and insurance agents who charge fees for their advice, as opposed to commissionable products.[88] It is necessary to note that simply providing advice and paying a fee has been a major focus of articles for the past fifteen to twenty years because of the concern about the sale of a product solely for the commission.[89] As a result, the extremely high commissions on such products have declined due to the competition of fee products and advisors.[90] (The transparency is generally for the brokerage industry products--stocks, bonds, and mutual funds. Commissions for insurance products have seen little disruption.)

But recognize that a bad advisor is a bad advisor, fee or otherwise, and that if you do not have a knowledgeable agent, the end result will often be lost money no matter the remuneration.

Also note that some fee products may cost more than commissionable products, most notably life insurance, and may not perform as well. But, where applicable, a fee product can offer a substantial reduction in costs and that can provide a large increase in returns over time.[91]

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88. *See* Carl B. Wilkerson, *The Status of Broker-Dealers Engaged in Investment Advisory Functions: Muddy Waters Slowly Clearing*, SN034 ALI-ABA 609 (2007).

89. *See id.*

90. *See* Jonathan Clements, *Due Diligence: The Five Key Rules to Heed Before Hiring a Financial Advisor*, WALL ST. J., May 31, 2006 at D1.

91. For example, assume $100,000 at 7% gross for ten years, and you pay 1.5% annually in fees and a 4% front-end commission. That leaves $96,000 net after commission earning 5.5% net. In ten years that would grow to $163,982. Again, assume the same situation with a no-load fund (no upfront fees) and a .5% annual fee for running the fund. That leaves 6.5% net. In ten years, that is $187,714. That is a huge difference, but the numbers can be deceptive--was the consumer actually able to pick the right no-load funds directly? Can the client do asset allocation? If not, perhaps they need assistance from a fee planner. Let's say that cost was .5% annually. The net return is now 6%, and the total return for ten years would be $179,085.

INVESTMENTS AND INVESTORS

INVESTORS

A securities broker wishing to charge a fee for advice must be a Registered Investment Advisor (RIA) either with the SEC or with the particular state.[92] The registration does not imply particular competency, it merely describes the background of the advisor and what and how they will charge.[93] This fee service has reached prominence since the mid-1990s, primarily as it reduced the focus on commissioned equities products. It certainly is a viable concept when using mutual funds, because there are a huge number of no-load funds that cover most investing allocations, such as Vanguard and Fidelity funds. However, advisors may still charge 1% to 3% annually for the 'right' to maintain the account, providing such services as changing allocations and rebalancing. This extra charge can easily negate the advantage of a no-load fund. Also, higher fees may accrue when commissioned agents use loaded funds and also charge fees. The consumer must still do some homework to determine if the fees are justified and the advisor worth the cost.

To minimize costs and still get advice, it is possible to engage a CFA using no-load funds for a .25% annual fee.[94] If a consumer needs ongoing financial planning help--college, retirement, health care, estate planning, insurance--a fee upwards to 1% can be justified.[95] But paying excess fees to monitor an investment, where the basics can be had for as low as .25%, does not seem valid. However, that is exactly the situation

92. *See* Barry Y. Greenberg, *Hedge and Private Equity Funds – Recent Regulatory Developments*, 1687 PLI/CORP. 271 (2008).

93. *Id.*; *see also* Securities and Exchange Commission, *How to Register as an Investment Adviser*, http://www.sec.gov/divisions/investment/iaregulation/regia.htm (last visited Nov. 21 2008).

94. *See* Clements, *supra* note 90 (showing that if an investor's intent is to simply have an allocation designed and then monitored, just what is an extra 75% or more for the effort adding?).

95. *See* Jane Kim, *Money's Worth: Figuring Out How Much You Should Pay for Financial Advice*, WALL ST. J., July 19, 2006 at D1.

for the industry-advisors doing simplistic and borderline financial plans in order to get assets under management for a fee at 1% or better.

INSURANCE

Insurance is a convoluted and mind-numbing industry. When analyzing mutual funds, stocks, and the like, there are a myriad of services that can provide detailed statistics--Value Line,[96] Wall Street Journal, MorningStar[97]--to name a few. Obviously, one can misinterpret the data, primarily because economics over time can alter such factors as a sound allocation, but at least the advisor can actually see what was invested and where at almost any time. The same cannot be said of traditional insurance. There has never been any service that has provided analysis of the exponentially increasing products in the industry. There are services that provide insight to the financial condition of the company, such as A.M. Best,[98] Standard &Poor's,[99] and Moody's Corporation,[100] but they provide no insight to the inner workings nor the true viability of the individual products. The insurance companies keep the inner workings of the products pretty much a secret. Further, unless one is using a term policy or similar, the variability of a policy over time (mortality charges, expenses, and internal yields) can lead to all sorts of problems such as surrender charges, lapsed policies, and unexpected income taxes. In the context of estate and business planning, this analysis is enormous and critical, far greater than with everyday investments.

That being true, however, the consumer is between a rock and a hard place, because many need life insurance and must

96. Value Line, http://www.valueline.com (last visited Nov. 21, 2008).

97. MorningStar, http://www.morningstar.com (last visited Nov. 21, 2008).

98. A.M. Best, http://www.ambest.com (last visited Nov. 21, 2008).

99. Standard & Poor's, http://www.standardandpoors.com (last visited Nov. 21, 2008).

100. Moody's Corporation, http://www.moodys.com/cust/default.asp (last visited Nov. 21, 2008).

rely on an insurance agent to choose it.[101] Only an insurance licensee can provide industry information about the companies and their new products; the companies and insurance agencies send such material only to licensees and they buy the lists of agents from the various state insurance departments. Unfortunately, the communications are as intrusive as junk mail and telephone solicitors, and about 95% are nothing more than a focus on the best commissions and extra incentives for meeting selling quotas. But, it is the only way that one can get insight to current and proposed products and be able to derive any value from an insurance advisor. Of the remaining material, one will have to do additional research to determine the true viability of the product. This may also require attendance of sales and informational seminars to ferret out what is going on. It is hard and time-consuming, and there is little industry data on which to base an analysis.

Another problem is that the policy illustrations, while not legal documents per se, are designed to provide consumers with an idea of what they might anticipate in the future and the expected cash value returns. In the hands of a purely independent, knowledgeable, and objective advisor, these can be extremely helpful. But they are not used as such. They have become marketing spreadsheets with all sorts of irresponsible numbers introduced, including high inflated returns, low mortality charges, and minimal expenses in order to make products look better than those of competitors.

A fee advisor will supposedly take all this information and distill it into something understandable and possibly find a lower cost product. For the most part, however, that is not going to happen, either legally or competently. For example, the majority of at least thirty-five states have additional licensing requirements in order to charge a fee for providing insurance

101. Although there are internet sites that provide assistance, use them only if you are extremely healthy. Otherwise, you are likely to be turned into an unacceptable policy risk.

advice.[102] California, for example, has a mandatory Life and Disability Insurance Analyst License.[103] These are essentially the only entities in the state that can provide independent fee analysis on life and disability insurance policies. There are only about thirty-three licensees in the state, as compared with 170,000 sales licensees and agencies in the state.[104] There are about 8,000 CFPs. Comparatively, there is only *one* CFP (that is not a misprint) who has ever passed the exam and can offer comprehensive fee financial planning services in the entire state. The exam is very hard and there is nothing in other designations, save for the Chartered Life Underwriter and the Chartered Financial Counselor, that provides an in-depth insight of insurance.[105] As such, nearly all CFPs and CPAs--and most all other planners including those with NAPFA membership--act illegally in charging fees for comprehensive planning advice in the most populous state in the nation.[106] California told the organizations to get their agents properly licensed, but they refused, and some told their agents to keep providing "advice" but simply keep quiet about it. But one cannot be a fiduciary while acting illegally.

In summary, most planners lack the requisite skills or qualifications to even discuss insurance properly because the knowledge is largely confined to the companies that will not permit the information to be disseminated. An insurance licensee is often self-limited in offering good advice, because the commissions can override a true duty to consumers. Fee

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102. *See* Foster, *supra* note 9, at 143 fn. 4 (*citing* Skillern & Lubben, *State Regulation of Financial Planners*, 2 FIN. SERV. REG. 1, (Jan. 15, 1986)).

103. *See* California Department of Insurance, *supra* note 23, http://www.insurance.ca.gov/0200-industry/0050-renew-license/0200-requirements/life-disability.cfm.

104. *See id.* at http://interactive.web.insurance.ca.gov.webuser/licw_name_search$.startup.

105. *See* Agent Broker Training Center, *Chartered Life Underwriter (CLU)*, http://www.abtrainingcenter.com/CLU.asp (last visited Nov. 21, 2008) (providing an overview of the coursework and training required to successfully complete the certification tests).

106. *See, e.g.*, Letter from Errold Moody, Jr., *available at* http://blogs.tampabay.com/money/files/designations.pdf(last visited Nov. 21, 2008).

advisors are even worse in knowledge base, and most are illegally practicing the profession. Accordingly, it is hardly difficult to understand why so many people end up doing the wrong thing with life insurance policies and annuities. The governmental agencies are woefully understaffed, and they don't know how to analyze sophisticated products for the most part. They do not get involved until the scam is severe, but it is well after the fact and after the damage has been done.

If one needs insurance, pick a licensed advisor with a valid designation who has at least 10 years' experience. The use of a new agent--or certainly an advisor--with no experience or interest or license--is fraught with financial disaster.

THE CONCEPT OF RISK

Central to the concept of consumer advice and choice is understanding of risk over time and change of circumstances. Important calculations involve the diversity of investments and the likelihood and disclosure of both gain and *loss*.

DIVERSIFICATION AND CORRELATION

The concept of diversification is critical to understanding any interest and investment in such products as stocks, bonds, mutual funds, and ETFs. Investor understanding of diversification could have limited the problems that were caused by the Enron, Worldcom, and the dot-com disasters and the current real estate and credit debacles.

Diversification is **not** merely a mantra of "don't put all your eggs in one basket." That provides no statistical application and is useless in any formal proceedings to evaluate or remedy harm. Rather, the question is "how many stocks do you need in a portfolio in order to insulate it from unsystematic risk,"[107] or

107. Systematic risk refers to the movement of the market overall. Unsystematic risk refers to the movement of individual securities that are impacted by their own unique business. This uniqueness can be tempered by adding in enough non-correlated or randomly correlated securities so that the portfolio acts more like the

"how many stocks do you have to have in a portfolio for it to be properly diversified"? Prior to availability of information on the Internet, with day trading and immediate 24-hour international trading (starting in the mid 1990s), statistics tended to reflect that one needed fifteen to twenty stocks to 'mirror' the entire market.[108] The selection had to be random--not all the companies could be doing the same thing at the same time for the same reason. This effect is called correlation--how one company (or country) reacts to another given certain economic scenarios. If the sample stocks were highly correlated, for example if the companies were all involved in the same type of industry--autos, steel, rubber, and glass--the overall diversification is lost and one might need 100 or more stocks to attempt to mirror the index.[109] Even when picking various industries, such as transportation, pharmaceuticals, and finance, it is necessary to analyze many different areas and companies. Consumers, and their advisors, rarely have that capability.

Due to the proliferation of trading opportunities and the transfer of securities around the world and the clock, trading in individual securities has vastly increased in volume.[110] While the overall volatility of the entire market is roughly the same, the increased volatility of individual issues now demands at least 50 to 350 stocks to reach the same level of diversification as a few stocks would have accomplished fifteen to twenty years ago.[111]

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index it is trying to mirror.

108. *See* Andreas Fleckner, *Stock Exchange at the Crossroads*, 74 FORDHAM L. REV. 2541, 2567 (2006).

109. Correlation, serial correlation, and cross correlation is a statistical attempt in defining how one stock moves with or against the movement of another. And by how much? The problem with this- and similar to the use of historical numbers- is that it takes a period of time to determine how accurate the numbers are. Most analysts figure about a year. But by then the economy has changed, and it takes a sophisticated estimate as to where everything might now be. Consider the credit debacle, recession, and how the international movement of securities has and has not been impacted.

110. *See* Fleckner, *supra* note 108, at 2554-79 (explaining recent history of exchange and how it has become available to the masses).

111. *See* John Y. Campbell et al., *Have Individual Stocks Become More Volatile? An Empirical Exploration of Idiosyncratic Risk*, J. FIN. 1 (2001), *available at* http://kuznets.fas.harvard.edu/~campbell/papers/clmx.pdf.

No matter the number, the increase in complexity makes sound, unadvised consumer choices nearly impossible.

In sum, no one can say that they are a competent investor or advisor unless they know diversification *by the numbers.* No broker can gauge risk to the investor by a single security or within a portfolio without a calculation of diversification and correlation.

Mutual funds tend to be diversified in that they generally hold a number of securities in different types of industries. But the mixture of different funds in a portfolio--called asset allocation--must also address the element of correlation. The result of such an analysis should be provided to the prospective consumer in writing. The industry has not been required to do this, and, indeed, it is not even taught. That it is hard to do is no defense for not doing it. But one must have the knowledge base first and foremost, because an unknowledgeable entity trying this has, by definition, breached their fiduciary duty.

STANDARD DEVIATION AND VOLATILITY

Almost all the numbers presented to clients by brokers, planners, or computerized plans are deceptive at best and a lie at the worst.[112] Once again, the constraints limit a full analysis, but

112. Very few planners have the breadth and depth of knowledge to analyze a client's situation and independently determine what should be done. Consequently, some planners buy various software packages that supposedly determine the allocation of investments. The cost of these packages may range from just a few hundred to several thousand dollars. The programs indicate that some type of historical pattern/analysis is being used to reflect proper allocation. But does anyone know what is actually being computed? What correlation? What period of history? The best comment comes from a statistics professor who said, "You can use any calculator program on a test as long as you write the program. Otherwise you don't know dirt about what the program tells to you." I repeat the necessity of using a personal financial calculator and identifying what the inputs are. When all is said and done, the consumer really likes a computerized plan since they perceive a correctness and absolute indication of an allocation. And because they do not know what they do not know (and have made no effort to do any homework), this marketing element will hold its position for decades. This is not to say that certain programs may not be right(?), but unless you tear them apart, there is no way of knowing. Pundits should be aware that I have torn apart both insurance and planning programs and found them using incorrect numbers. I do not mean the assumptions were wrong--I mean the computations were wrong

this is the crux of the problem. If there is a financial goal in the future, certainly retirement, and some type of stock, bond, or mutual fund portfolio is recommended and utilized, the returns are invariably shown as a flat rate over time. Therefore there is "always" a nice lump sum amount of money that will be computed by a software program to be available. Such numbers are very easy to compute. But while it is true that time flattens out volatility, such analysis is generally deceptive. This is how it works in simplistic terms.

Volatility and standard deviation reflect how much the price changes around the norm. For example, if the average return for a stock over a year is 10% (roughly the return over fifty years), it statistically will fluctuate (about two-thirds of the time and called one standard deviation) from a -11% to as high as 31% (+ or – 21%) during a one-year period. But if the portfolio was held for a period of, say five years, the standard deviation will drop to 8% (simply divide the annual deviation (21%) by the square root of the years held (2.236)). That is quite a drop and implies that potential losses are reduced significantly over time. If "risk" is mentioned at all, what is portrayed is how volatility goes down over time. But volatility is NOT risk, ipso facto. Per Peter Bernstein, "[v]olatility is often a symptom of risk but is not a risk in and of itself. Volatility obscures the future but does not necessarily determine the future."[113] Nonetheless, the industry interchanges the two and then is able to project a 10% return (or whatever), hypothetically, with a perceived high degree of expectation. Heck of a deal. Except it is a complete fallacy, save by luck.

Risk is how much you have and can lose at any given point in time. For a regular equity allocation portfolio, over a period of five years, one is apt to have only 40% to 60% of what was anticipated.[114] It is true that one can have 40% to 60% or more

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(TransAmerica Insurance; American Express allocation software).

113. Peter L. Bernstein, *What Happens If We're Wrong?*, June 22, 2008, http://www.nytimes.com/2008/06/22/business/22view.html?ret=business.

114. Here are the statistical measures of standard deviation and projected losses. (Admittedly, the opposite side is true of returns. It is possible to have a huge

than projected, but that is not the point. It is how you need to focus on a goal, particularly retirement, when the investment is needed.[115]

An advisor cannot accurately name a flat rate of return with a variable product. While it is simple, easy to communicate, and easier for most potential consumers to accept, it is wrong and dishonest. Depending on the time frame, one can have far less than expected. Consider the following hypothetical investor,

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amount of money during retirement and at death. But that is not the real world of planning during retirement--it is to have enough funds given most market calamities.) The longer you hold a security, the greater the risk of a major loss. Assuming a 20% initial standard deviation and a hold period of five years, one uses the formula (1- .0894)5th and it yields .626. This means that the final five year wealth may be only 63% of projected (and that is just for one standard deviation- a 68% probability in itself. If one uses three standard deviations, the risk is even greater). The statistic represents a 37% loss from projected value- far greater than a one- year 20% swing. INVESTMENTS by BODIE, KAHN AND MARCUS, 224 (Richard Irwin Inc.) (1989):

> . . . [T]ime diversification does not reduce risk. Although it is true that per year average rate of return has a smaller standard deviation for a longer time horizon, it is also true that the uncertainty compounds over a greater period of years. Unfortunately, this latter effect dominates in the sense that the total return becomes more UNCERTAIN the longer the investment horizon. Investing for more than one holding period means that the amount at risk is growing. This is analogous to an insurer taking on more insurance policies. The fact that these policies are independent does not offset the effect of placing more funds at risk.

I emphasize the date of the book of 1989. The formula for the position of loss is not a new calculation just invented. It has been known far in advance of the 2000- 2002 financial debacle, but remained universally unacknowledged by the securities and planning industries. Consumers are unaware of this material. They cannot be expected to search it out either. However, true advisors must seek it out, understand it, use it, and properly convey the implications to consumers.

If one takes a twenty-year hold period, the risk of loss (obviously) increases. For long-term consumers who are under the guise of a continued buy and hold, the risk of a loss is so excessive as to make a retirement a far greater risk proposition than has ever been addressed by the industry. Assume a 20% initial standard deviation and a twenty- year period. The standard deviation drops to 4.47%. The appearance of low risk. But the risk of loss is calculated by (1-.0447)20th= .40. That means that the end result could be only 40% of what is expected (and this is based on just one standard deviation). This is critical information to any investor. It is mandatory that an investor be presented a detailed statement of this statistical risk. These numbers are not far-fetched, nor purely theoretical, with no application to real life. In fact, it is the reality that these numbers have a direct bearing on the lives of hundreds of thousands of consumers, literally all retirees, and pension plans. That is exactly what happened in 2000- 2002 and is happening in 2008.

115. This is not an isolated occurrence. The Author has worked on plans from American Express, UBS, and others. Risk is not defined correctly and the clients are clearly misled.

who had $100,000 in the market for ten years starting in 1990. This investor would see a huge gain of around 17%, varied due to exact dates, dividend adjustments, etc., for a total of close to $500,000 before the dot-com era went under. The investor likely used that record to define a lifestyle and anticipated retirement. In the following three years, however, that investor lost about 44% and had only $270,000. Did this happen to many? Yes. The losses for the retirees during that period was estimated about one trillion. The current financial debacle is far from over, but estimates indicate that over two trillion in retirement funds have now been lost just in the last fifteen months.[116] Didn't they know that such risk was a definite probability? Generally no. It is not taught to advisors and is not tested; accordingly, it is not communicated to investors. It also would slow sales by introducing more uncertainty and a healthy appreciation of the real risk to the potential investor, certainly in sales of single-issue securities.

The theory for loss is based on statistical numbers that can rarely be violated. But it is not necessarily real life in toto. The point is this--one does not have to be in the market for a long time to suffer significant losses as the formula implies. Anyone putting money into the market in 2000 went on to suffer immediate losses. The scenario is not much different for the last year. Formulas do not tell you when the market might retrench nor by how much. But a financial debacle at the initial stages could decimate a portfolio to the extent that it might never recover before a retiree's death. Can these debacles be predicted and possibly avoided? Yes, though not with perfect precision. See inverted yield curve addressed previously.

For a real life example of how this plays out. Here are the requirements for an agent in dealing with suitability from Investopedia.

The concept means that an investment is appropriate in

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116. Jennifer Levitz, *Workplace Retirement Plans Suffer $2 Trillion in Losses*, Oct. 8, 2008, http://online.wsj.com/article/SB122342685954113657.html?mod=googlenews_wsj.

> terms of an investor's willingness *and* ability (personal circumstances) to take on a certain level of risk. It is essential that both these criteria be met. If an investment is to be suitable, it is not enough to state that an investor is risk friendly. He or she must also be in a financial position to take certain chances. It is also necessary to understand the nature of the risks and the possible consequences.[117]

Note that the definitions from literally every site suggest the same thing in reference to risk, that the investor can grasp and manage risk.[118] It is effectively gibberish, since risk can be evaluated and explained by few advisors, let alone the general public. The statistical numbers are not identified. Further, the majority, at least 95% of all advisors, do not have the capability to calculate the risks to the customer, and those that do simply fail to do so.[119]

The obvious issue, at least hopefully, is that the industry is suggesting that the consumer is the one who identifies and bears the burden of risk. This is illogical in the extreme given the client's lack of knowledge and an advisor's fiduciary duty. One cannot simply discharge a fiduciary duty of a perceived knowledgeable advisor by shifting responsibility to the ignorant clients. Such a shift cannot relieve the advisor of the fiduciary responsibility for subsequent problems and losses. It matters not that the agent would not know the facts. It matters that the agent and the firm have accepted the responsibility to know and proceed accordingly with clients. The point being is that they should divulge the facts even though it might kill the sale.

Some may find this criticism too harsh. However, Enron was harsh, the dot-com crash was harsher, and the current housing debacle and credit mess harsher still. It should not be possible that such entities as Merrill Lynch, Bear Stearns, and Credit Suisse can cause a meltdown that created a recession or

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117. *See* Brian Bloch, *Investment Suitability 101*, http://www.investopedia.com/articles/financialcareers/08/suitability.asp (last visited Nov. 21, 2008).

118. *See id.*

119. This is not a diatribe--I have worked in the industry for over 30 years with 'regular' agents, CFPs, and the like. The sophistication is absent throughout.

threatens a depression.[120] Did they not understand risk?

No.

URGING GOVERNMENT OVERSIGHT

Since the mid 1990s, due in part to his instruction on the various securities licenses, the author attempted to get the National Association of Securities Dealers (NASD) and FINRA to provide proper education to the brokers and securities arbitrators. The author had acted as a NASD arbitrator for a number of years, and he never knew a securities attorney or arbitrator who knew diversification by the numbers. The policy statements predicated my action, in part, by such entities as the SEC, NASD, NASAA, and AARP, who always indicated that they were there to help and protect the public. Primarily hollow words. In a 1995 letter to the NASD, the author pointed out that "Agents in the business are rarely taught anything of real world use through the licensing training [and I indicate the specific shortcomings] . . . Correlation and asset allocation – also necessary to understand suitability – are essentially missed in the entirety . . . agents are woefully unprepared to provide even the most rudimentary analysis of a client's needs." Over the past decade, the author has urged change to the SEC regarding arbitrator reform, to Federal Chairman Bernanke on consumer education, to Joe Borg of the (NASAA), and to Mary L. Schapiro, CEO of (FINRA,), with no results.

Indeed, in a 2006 speech, Schapiro observed:

> . . . [This] subject [is] one that will surely shape the role of regulators well into this century–investor education

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120. Many U.S. securities firms buy mortgages and repackage them to banks and other institutions. See CMOs (collateralized mortgage obligations) above. They marketed them as being safe and secure. But such ratings were undercut by the lack of formal underwriting when effectively anyone over the last few years could buy a house with lousy credit. And they used loans that could escalate. Nobody thought that this was a problem because the conventional wisdom states that "home prices do not go down." Wrong. When they did, all the repackaged loans got marked down substantially and caused a worldwide credit crisis. See WALL ST. J., N.Y. TIMES, or any major business section for the main companies who offered such packages. Arrogance and incompetence prevailed.

> as investor protection. I believe very strongly that the people best able to protect investors from mistakes, misunderstandings, deception or outright fraud are the investors themselves–if they are knowledgeable about investing and the markets. I cannot overstate the importance of this, particularly given that we're facing a looming crisis–the impending retirements of millions of baby-boomers, many of whom are financially ill prepared to stop working.[121]

The statement is disingenuous at best. More pointedly, the idea that FINRA and related regulatory entities are going to bypass the industry and provide the necessary insight to consumers is absurd. Schapiro confirmed that when she asserted that the NASD "is a procedural entity not a substantive one."[122] None of the government entities, including the SEC, FINRA, NASAA, and state insurance departments provide effective consumer education as described here. That is not going to change because of lack of funds, staff, and knowledge and the sales orientations and motivations rooted in the financial industry. Further, the reply that the author got from the NASD in the 1990s sums it up – "they [the industry] will never allow it [education of the fundamentals] since it would slow sales." Sad, but absolutely true.

BEHAVIORAL FINANCE AND CONSUMER COGNITIVE IMPAIRMENT

So far the focus has been the breach of duty of the industry. But there is also the issue of the absence of research by the consumer. For over thirty years, the author has tried to get average consumers/investors to do their reading homework to learn to protect themselves. It has not worked and I see no changes forthcoming. If investors do not read the material necessary to protect themselves, as well as limit their emotions

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121. FINRA, http://www.finra.org/Newsroom/Speeches/Schapiro/P017671 (Last visited Nov. 21, 2008) [hereinafter Schapiro].

122. The point was that FINRA merely provided the avenue for complaints, not the mandatory education of brokers or attorneys. That is true; that is what they do, except it does little to help the average consumer who knows effectively nothing about risk (but neither does the government).

(which may not be possible without an emphatic statement by some entity they will listen to, Oprah, perhaps), they tend to use irrational practices in dealing with investments.

Decades ago, theory held that the selection of investments seldom deviated from a rational process.[123] But around the 1950s,Professors Kahneman[124] and Tversky[125] conducted research that shows this was not correct. Kahneman, who won a Nobel Prize for work on the subject, explained:

> A basic assumption is that in standard economics and in financial analysis, people are assumed to be rational. What is meant by that is not that they know everything, but that they have a consistent system of beliefs, that they act on their beliefs and that they have consistent preference. Now when you abandon those assumptions of rationality or similar assumptions that people make within the context of finance, and you accept assumptions that are psychologically realistic, then you are doing behavioral economics, and if you are doing finance you are doing behavioral finance.[126]

During the last ten years, studies have confirmed and detailed likely investor thinking. Frank Caliendo[127] and Kevin Huang[128] describe the results:

> With growing empirical evidence on persistent overconfidence, much attention has been paid to the question of why people are overconfident and experience does not lead them to become more realistic, especially in activities like investing where results can be calculated ex post. Existing studies demonstrate that self-serving attribution bias (past successes tend to exacerbate overconfidence as people take too much

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123. *See* Investor Home, *Psychology & Behavioral Finance*, http://www.investorhome.com/psych.htm (last visited Oct. 13, 2008).

124. David Kahneman Autobiography, http://nobelprize.virtual.museum/nobel_prizes/economics/laureates/2002/kahneman-autobio.html (last visited Jan. 6, 2009).

125. Amos Tversky Biographical Information, http://en.wikipedia.org/wiki/Amos_Tversky (last visited Jan. 6, 2009).

126. *See* Investor Home, *Psychology & Behavioral Finance*, http://www.investorhome.com/psych.htm (last visited Jan. 6, 2009).

127. Frank Caliendo - Biography, *available at* http://fcaliendo.com (last visited Nov. 21, 2008).

128. Kevin X.D. Huang - Biography, *available at* http://ideas.repec.org/e/phu15.html (last visited Nov. 21, 2008).

> credit for their successes, while past failures tend to be ignored as people blame their failures on forces beyond their control), confirmatory bias and cognitive dissonance (tendency to overweigh data confirming prior beliefs while to dismiss data contradicting prior beliefs), illusion of control, and forces related to evolution and tournaments or contests, can all contribute to generating persistent overconfidence throughout the life cycle.[129]

Conformity, on the other hand, causes people to change their behavior as a result of pressure from others. One of the major findings from academic studies of the behavior of individual investors is that it is the very nature of people to make irrational investments.[130] If you sell a stock that is currently worth more than you paid for it, then you can pat yourself on the shoulder for a successful investment. When you cut your losses on the stock, in contrast, you have to accept punishment right now for having made a choice that did not turn out well. It is not surprising that people prefer rewarding themselves rather than punishing themselves. On average, you will do much better if you sell losers and hang on to your winners. This is a pretty good example of normal investor behavior leading to generally bad outcomes.

Simple statistics include that men are more overconfident and trade unnecessarily far more than women.[131] The disposition effect: when people are selling stocks from their portfolio, they tend to sell winners and hang on to their losers. Cognitive dissonance causes people to rationalize actions that differ from their own preferences. Herd behavior causes us to invest simply because others are doing it. The author does wish

129. *See* Frank Caliendo & Kevin X.D. Huang, *Overconfidence in Financial Markets and Consumption Over the Life Cycle* (Research Department, Federal Reserve Bank of Philadelphia, Working Paper No. 07-3, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=961367# (last visited Nov. 21, 2008).

130. *See* Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling? – Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 987-1005 (1992).

131. *See* TIAA-CREF, *Are You a Rational Investor?*, 3, http://www.tiaa-cref.org/administrators/pdf/admin_library/C38907.pdf (last visited Nov. 21, 2008).

to make specific reference to this (and then to Affinity Scams) as two of the leading errors that mislead the public (and target the elderly). People choose to use behavioral finance instead of reading and understanding their own investments. For a historical example, look to the meltdown of the dot-com world in 2000. The National Association of Investment Clubs (now Better Investing) membership peaked during the dot-com boom.[132] Between 2004 and 2008, membership decreased by 55%.[133] Thousands of "investors" milling around in a non-sophisticated environment found the next best stock or fund that would supposedly produce fantastic returns--only to finally recognize that they and their 'sophisticated' compatriots were clueless to the elements of diversification or to economic risk. There is simply no way that an organization could lose 55% of its members when it was offering competent advice in a professional setting. The author is not addressing the fallacy of getting advice from co-workers, friends, or fathers. He is talking about an organization that touts its professional ability to educate the masses about investing. But if one visits their website, you will find a major orientation towards an analysis of stocks. As William Bernstein said, "[h]uman beings cannot pick stocks, period."[134]

The point with the above commentary is that it may be next to impossible to get people to actually orient themselves to being objective about their investments. Just how is the above supposed to be presented to the public to make them aware and, more so, to make them react? It's a rhetorical question since I know of no answer. People like what feels good, tastes good, looks good. Reading and thinking are not in that category.

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132. Jen Haley, *How Investment Clubs are Reacting to Market*, Nov. 3, 2008, http://www.cnn.com/2008/LIVING/personal/11/03/investment.clubs/index.html.

133. *Id.*

134. Nalini Indorf Kaplan, *7 Investing Mistakes You Cannot Afford to Make*, http://ezinearticles.com/?7-Investing-Mistakes-You-Cant-Afford-to-Make &id=1560421 (last visited Nov. 23, 2008)

AFFINITY SCAMS

This is another element of behavioral finance and is an extension of the refusal to do research of literally any type. The States' Attorneys General have noted this as one of the main reasons why so much money is lost. It has everything to do with clubs, affiliations, and, absolutely, churches. When people are in association of others with similar interests, they tend to let their guard down. They trust the others in the group almost irrespective of the activity— golf, for example. A great social activity for business. But note the author said "social." It has nothing to do with competency. For example, religious affiliations are one of the greatest areas for soliciting victims of investment fraud, or just to get clients to begin with. The Lutheran Brotherhood Broker Dealer organization used to give a church to an agent as his "farm area." But they have nothing to do with competency.

The most obvious example imaginable is Madoff. $50 billion lost due to a personality defined as a Jew, at the Palm Beach country club, at the Glen Oaks Country Club, and whatever non-economic arena that impressed prospective clientele.[135] "Madoff was a member, and other members sought introductions in hopes of being allowed into an even more exclusive investment club that brought steady, double-digit returns even when the market was down."[136] Statistically, such returns have never occurred with regularity, nor will at any time in the future. But irrational human behavior can universally eradicate rational thought and reasonable research.

THE SOFT GROUND OF REFERRALS

The industry is heavily focused on referrals from clients.

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135. Alan Fleur & Christine Haughney, *Standing Accused: A Pillar of Finance and Charity*, N.Y. TIMES, Dec. 13, 2008, at B1.

136. *Greg Allen: Florida's Palm Beach Rocked by Madoff Scandal* (NPR radio broadcast Dec. 16, 2008).

Agent training simply tells new agents that if they wish to be successful, they must get at least ten referrals from a prospect even if they did not make a sale to the initial client.[137] Consumers used to give such names only to get the salesperson out of the house. The agent then approaches the unsuspecting new client who assumes the agent has been thoroughly checked out by their friend/relative/co-worker. Journalists regularly suggest one get a referral when seeking assistance.[138] It is a potentially reasonable position, but with the same result. No homework. Further, why would one want a referral to an entity with no understanding of risk? All in all, it is the consumers' tendency to use all sorts of esoteric mannerisms, outside of hard work, to select the agent to do business with. No matter the rationale, it boils down to trust. But generally unsubstantiated trust. Yet the frauds and losses seem to keep repeating, and in literally every bad investment scenario, the one singular universal quote is, "but I thought I could trust him," for all the aforementioned reasons.

WIDESPREAD EDUCATION

Here is a continued quote from FINRA CEO Mary Schapiro in 2006 on the dearth of knowledge. "Making matters worse is that Americans, by and large, are not particularly well-schooled in how to manage their own finances, nor do young adults enter the workforce with even a basic appreciation of the importance of starting to save and invest for retirement early."[139]

Schapiro is absolutely correct that Americans need help with finances. But nice words don't cut it when FINRA does

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137. *See* Peter Bates, *Priming the Prospecting Machine*, http://www.advisortoday.com/resources/prospectmachine.html (last visited Nov. 21, 2008); *see also* Annuity Pro Shop, *The Most Endorsed and Affordable Annuity Marketing and Sales Training*, http://www.annuityproshop.com/referredleads.html (lasted visited Oct. 14, 2008).

138. *See, e.g.*, Letter from Errold Moody, Jr. RE: California Financial Literacy Summit, *available at* http://www.efmoody.com/PRMay2008.html (last visited Oct. 14, 2008).

139. Schapiro, *supra* note 121.

nothing to help the educational process of its own agents. Unfortunately, it is not the only floundering organization.

At the April 2008 California CPA symposium on Financial Literacy, there was some excellent material on savings, credit cards, and budgeting that was being introduced to the schools.[140] However, their offering regarding investing will lead more and more consumers to the poor house. It consisted of a fluff video produced by PBS, showing a young black kid with a single mother making good by buying some Nike stock.[141] Just Nike stock. The author does not dismiss his effort in looking at a Price/Earnings (P/E) ratio. The author is happy that he made money and could now buy lots of Nike shoes. But he was now "teaching" other kids how to invest in this high-risk manner. The video was being shown in many schools (and to 500 attendees at the Summit) and getting a lot of interest from the kids.[142] But most of it for the wrong reasons. The interest lay in the fact of how easy it was to look at a couple of statistics, buy one stock, and make a killing. That is gambling, pure and simple. The purchase of a singular stock violates just about every fundamental understanding of risk since the singular position was 100 to 500 times greater than the market itself. This will simply lead to more unknowledgeable consumers hoping to make it big time by using a single issue. Enron, Worldcom, etc. should have made this type of material obsolete, and condemned into nonexistence, as it is both unconscionable and irresponsible.[143] Yet, the old adage echoes true, *those who do not learn from the past are doomed to repeat it.*

CONCLUSION

The financial services industry has failed to evolve to include the fundamentals of investing, including informed statistical evaluation of risk and diversification. One likely

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140. *See* Moody, *supra* note 138.

141. *See id.*

142. *See id.*

143. *Id.*

motivation for resistance to the inclusion of such fundamentals is that the knowledge would reduce sales simply because risk is identified. The consequences are not trivial. Such knowledge clearly could have limited the irresponsible exposure that caused the most significant market upsets in the past decade and might cause prolonged recession, not just in the United States, but also worldwide, arising from the current housing crisis debacle. The solutions lie not only with the industry, though the industry must stop hiding the ball and begin to serve its own consumers and better educate its staff. The current criticism for the failure of the SEC to investigate and shut down the Madoff Ponzi scheme is absolutely acceptable.

An effective solution must include the elements of behavioral finance and take into account the fact that human beings often do not act rationally with regard to the purchase and sale of investments. For the elderly, the problem is more pronounced since elders do not have the luxury to make up losses from unacceptable investments. In addition, the increasing number of elders with disabilities with modest retirements, who are isolated from the community and competent financial advice, are being grossly victimized due to the their known vulnerabilities and fear of loss, susceptibility to deceptive sales tactics, and outright frauds being perpetrated by unscrupulous persons.

Buried in fundamental commonsense lies a singular screening tool. There is one singular element that has the potential to help avoid at least 85% of all bad investments and scams.[144] ***"Never, never, never give money to anyone unless they have and can effectively use a financial calculator. You do not give money to anyone who does not know how it works."***[145]

144. MOODY, *supra* note 76.

145. *Id.* (FORBES thought it was particularly valid when they stated, "[E]xcellent suggestion. Either they don't know or they don't care." Additionally, the CFA organization is using the statement in their licensing training. But how many of America's elderly are reading FORBES before they turn over their nest egg to a slick, unqualified financial scam artist? The correct answer is few, so it is imperative that those professionals serving this highly susceptible group advise and counsel them in a manner that will protect their financial future.).

From those advisors that are left, the author would choose only a degreed planner with at least 10 years of experience. He would demand a proper definition of diversification and risk before permitting a client or family member to rely upon their advice. They must have an insurance license if just solely to get the current material within the industry. By the time you get through some more questions, there will not be many choices left. Moreover, they may not belong to your church, and they may not even live in your city. So be it. People simply have to start to realize how important their money and financial future is.

Ultimately, knowledge must encompass real life risks associated with investing, including individual, public, and private opportunities. The investor need not figure out various sophisticated derivatives, but they must learn the fundamentals and the associated risks within these basic investment vehicles. Then the individual should be able to ask the pertinent questions of those entities (Merrill, Lynch, Bear Stearns etc.) who appeared clueless as to their own activities and have been found wanting in upholding the fiduciary duties to those they serve, leaving investors with the heavy responsibility of self-education.

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