

Ethics In Financial Planning

Introduction:

What do people want in a financial planner or financial advisor, more than anything else? Investment savvy? Experience? Credentials and education? Positive returns and overall good financial results? Yes, I believe each of these is important and adds value to the client-advisor relationship. Most people rightly expect a financial advisor to produce positive results. However, at the core level, I do not believe any of these provide the answer to the question above. So what do people really want in a financial planning relationship? I believe there is a one-word answer. Trust! Ultimately, they want to work with someone whom they can trust.

The Problem:

If I'm right, you wouldn't think this would be too hard to deliver. However, finding people and organizations in whom consumers can reliably place their trust seems to be one of the more difficult of life's tasks. Don't just take my word for it. Take a walk back through news clips of the last several years (or just about any multi-year period you care to choose). On the whole, how would you say we have been doing in the area of ethical business dealings? Not so good. Sure, there are shining examples of people and organizations that consistently take the high moral/ethical ground. Not to minimize them, but they stand out because of their relative scarcity.

Why does it seem to be so difficult to find business people or organizations who regularly walk the high ethical path? Why can it be such a trial to find advisors and companies in whom consumers can place their trust?

To attempt to identify a short list of absolute answers to that question would be nearly impossible. There are, of course, many reasons why people (and from here on we will focus on individuals, rather than organizations) struggle with making good ethical choices. Greed, fear, selfishness, overriding concern for increased profits and the bottom line, pressure from others: each of these, individually and collectively, contribute to the problem.

If the preceding identifies the problem, is there a reasonable "win-win" solution? I believe that there is. No, I don't think there is a magic pill to be swallowed that will immediately make everything better. I do think though, that some education, some re-thinking, some commitment, and yes, some regulation, can go a long way toward healthy ethical growth and the creation of a greater level of consumer trust.

In this article we will take a look at some of the attempts to regulate and/or legislate ethics, giving particular attention to the financial arena. We will also look at attempts to codify ethical behavior. Finally, we will try to evaluate application and results. First, though, let's take a look at how people develop ethically.

Ethics in General:

Lawrence Kohlberg, a psychologist and professor doing research at Harvard University, was an influential theorist on the subject of ethical or moral development. Kohlberg's work has detractors (notably Carol Gilligan, who argues that Kohlberg's theories are more applicable to males than to females), but we will use it as an acceptable guide to discussing the topic.

Kohlberg suggested that there are three basic levels of moral (or ethical) development: Preconventional, Conventional, and Postconventional. The Preconventional level is the earliest level of development. At this level, right and wrong are determined by reward and punishment, that is, enlightened (or not so enlightened) self-interest. "If I don't do what I'm told, I will get a spanking; if I do a good job at work, I will get a raise."

Some people never move beyond this level, but for those who do, Kohlberg identifies the next stage of development as the Conventional level. People at this level tend to define ethical activities in terms of peer group orientation. Peer groups can be of many types, including family, friends, church or other religious groups. Beliefs of the peer group become guiding principles in determining whether an action is right or wrong. "Why do you believe it's wrong to steal? My parents taught me that, or my church teaches that." If you have ever heard the term "group think" this is a good example.

The third level of ethical/moral development is the Postconventional level. At this stage, people determine right and wrong by what is universally good. In other words, the Postconventional person would determine what was best for society as a whole, and then act in that way. "I believe in sustainable farming, because it's good for the land, good for the crops, and good for consumers."

If you were to present an ethical problem to a room full of people, it is not too hard to imagine that the responses are likely to encompass each one of these stages of development. The next question then is, why does this matter, and what does it have to do with ethics in financial planning?

Ethics in Financial Services/Planning:

Two ethical issues relevant to financial planning arise. First, as we have seen from Kohlberg, some individuals get "stuck" at the Preconventional or Conventional levels. This means that when making ethical decisions, these people respond from the perspective of reward-punishment and/or peer pressure. Financial professionals selling products based solely on the fact that they must meet a quota to keep their job, and when do so they get a high commission payout, exemplify this type of thinking. Second, because of this, and because it seems necessary to create a standard of professional ethical financial activity, the government has stepped in, along with a number of financial organizations, to create regulations and codes of ethics. You need only look to any number of recent abuses to see the need for a recognized set of standards (along with significant punitive measures for noncompliance).

In fact, the government – principally the Securities and Exchange Commission (SEC) – has created enough new regulatory requirements, that a recent article in the *Journal of Financial Planning* (April, 2005) asked the question, “Are compliance issues changing the nature of the financial planning business?”. One of the quotes within the article from a long-time financial planner said, “I’ve been in the business for 15 years. Now paperwork takes up 25 percent of my day” (*Journal*, April, 2005, p 40.). Perhaps a more telling quote from the article is this one, “In the regulators’ efforts to protect the public through paperwork, they are actually limiting most Americans’ access to broadly qualified, personalized financial advisory service.” (*Journal*, April, 2005, p. 37).

Not that the government is new to the practice of regulating financial advisors. Back in 1940, the Investment Advisors Act was created specifically to regulate the business of giving investment advice. The SEC itself was created by Congress in 1934, with a mission to protect investors and maintain the integrity of the securities markets. Unfortunately, we have seen that the results of these regulations leaves something to be desired. So, does this mean government regulations are not necessary or viable? That would be an incorrect assumption. As identified above, some level of regulation seems to be required. However, the question remains, what is the real value and the real cost to the regulations . . . and there is a cost. Said another way, do the results validate the cost?

Non-governmental organizations, such as the NASD (National Association of Securities Dealers), the NYSE (New York Stock Exchange), and the CFP (Certified Financial Planner) Board of Standards, have also added layers of guidelines and regulations for their constituents. Each of these organizations now have codes of ethical conduct that must be honored by their members. Failure to do so is penalized, perhaps up to the level of revocation of an individual’s ability to do business and retain affiliation with the organization.

Again, the question is, has all this regulation solved the problem and created an environment where every individual advisor or planner operates ethically? Sadly, no. Even a cursory review of cases of arbitration and organizational reviews show that there are still plenty of individuals who struggle with ethical conduct.

Applicability and Results:

So, is there a better way? Perhaps there is some internal guideline that will help to accomplish the task. I believe that, at least at some level, it comes down to determining your purpose. If your purpose in financial planning is just to make money, then the ethical/moral high ground will remain an elusive dream. It's not that making money is bad. It's not that making boatloads of money is bad. But if doing so is your purpose, your ultimate goal, then ethics is just one more obstacle to achieving your goal. Those who choose this path might be said to be “stuck” in Kohlberg’s Preconventional or Conventional levels.

On the other hand, what if your goal is to benefit others; to help the community? Then financial planning – even making boatloads of money and creating great financial success - becomes a tool to achieve that goal, rather than being the goal itself. If the universal good – Kohlberg’s Postconventional level – is your goal, then ethical actions will be the norm. Why? Because you would never choose to do things that would ultimately harm the very people you are trying to help.

Summary and Conclusion:

Not long ago, there was a story in a Denver newspaper about a woman who had just won a million-dollar NASD (now, FINRA) arbitration settlement against a brokerage firm. It seems that 18 years ago, as a widow with two small children and following the advice of the brokerage firm, she invested half a million dollars of her late husband’s insurance money. The investment went sour, she didn’t recover the money, and sued the firm for negligence. The brokerage firm still doesn’t admit it did anything wrong (at least publicly), but the NASD (FINRA) arbitration panel disagreed, awarding the woman more than a million dollars.

Why bring this up? It serves to illustrate the problem of ethical dealing in the financial planning arena. Frankly, I don’t believe that any number of ethical codes will resolve this type of problem; and the regulators took 18 years to take action.

So what is the solution. Each advisor, personally, must evaluate every decision, every action, on the basis of the highest good. It was said once this way, “Do unto others as you would have them do unto you”. Not bad advice, and especially considering the increase of punitive awards against those who are perceived as not dealing ethically, it makes good financial and business sense.

As a consumer, look for trustworthy advisors. Education and industry credentials are a good starting point, but not a panacea. Do your own due diligence. Look for advisors who have agreed to work under an organizational code of ethics. Ask questions. Check references. Talk with existing or former clients. Don’t get greedy. What, don’t get greedy? Yes, all too many people get hurt financially by trying to beat the system or get rich quick. When tempted by the next “sure thing” promising that you can invest a dollar and get a million dollar return: do so at your peril.

I believe the solution requires ethical behavior from both sides: advisor and client. One-sided won’t work. However, both sides working together can begin to create an environment that is ethically sound, with realistic expectations, operating with trust and integrity. . . and that’s a win-win solution.

— Michael Snowdon, CFP®